The Accounting Review

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Editor: Frank P. Smith, University of Rochester, Rochester, New York
Professional Examinations Department: H. T. Chamberlain, Loyola University
Te achers' Clinic: S. P. Garner, University of Alabama
B. k Reviews: Charles J. Gaa, University of Illinois
A iation Notes: E. Burl Austin, Oklahoma A. and M. College

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DEPARTMENTS

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CONTRIBUTORS TO THE APRIL NUMBER

J. William Hope (*The Uniform CPA Examination*) of J. William Hope & Company, is Chairman of the Board of Examiners of the American Institute of Accountants.

Hale L. Newcomer (*The CPA Examination and also Excerpts from the Report on the Uniform CPA Examination*) of the University of Illinois, is Chairman of the Committee on CPA Examinations of the American Accounting Association.

T. A. Budd (*The Effects of a National Testing Program on Accounting Education*) of the University of Pennsylvania, is Chairman of the Committee on Testing of the American Accounting Association.

Hermann C. Miller (*Expense and Accounting Concepts and Standards*) is Professor of Accounting and Chairman of the Department of Accounting at Ohio State University.

A. J. E. Child (*Case Studies in Internal Auditing*) is Assistant Treasurer of Canada Packers Limited.

A. B. Carson (*A "Source and Application of Funds" Philosophy of Financial Accounting*) is Assistant Professor of Accounting at the University of California, Los Angeles.

John C. Grace (*A Controller's Conception of a Modern Annual Report*) is Controller of Maremont Automotive Products, Inc.

R. W. Coleman (*The Role of Accounting in Management*) is Professor and Head of Economics and Business Administration at West Virginia University.

Rufus Wixon (*The Measurement and Administration of Income*) is Professor and Head of Accounting at the University of Buffalo.

Melvin C. Wren (*The Chamber of the City of London*) is Assistant Professor of History at Montana State University.

Richard H. Homburger (*Forfeited Capital Stock Subscriptions*) is Assistant Professor and Acting Head of Business Administration at West Virginia State College.

The Accounting Review

Vol. XXIV APRIL, 1949 No. 2

THE UNIFORM CPA EXAMINATION[1]

J. WILLIAM HOPE

A MEETING OF the American Accounting Association is a particularly good place for the Chairman of the Board of Examiners of the American Institute of Accountants to discuss the Uniform CPA Examination.

It is here that I would expect to find the sort of constructive criticism that can be most helpful in the continuing efforts of our board to supply an examination which will, if possible, better satisfy and more fairly serve the public, the profession, and the candidates, as well as the examining boards of forty-six states, four territories and the District of Columbia.

I am also pleased to have the opportunity to express the thanks of the board of examiners to Hale Newcomer and his American Accounting Association committee who are now engaged in a study of the processes of preparing and grading the uniform examination. Even though this committee may report no other conclusion than that as good a job is now being done as can be expected under the difficult circumstances of conducting a written examination of candidates who, for the most part, have passed the student stage, theirs can be a valuable contribution to the profession. We are sincerely grateful to them for having accepted this assignment.

It is not my purpose to go into the details of the work of the board of examiners. I prefer to discuss some of the varying pressures which are exerted by the many interests concerned with the results of determining who may be permitted to practice public accounting as a Certified Public Accountant.

In every state, district, and territory of the United States there is a statute which sets forth the requirements, within its jurisdiction, for the examinations of applicants for the certificate of Certified Public Accountant. It must be accepted that these laws were promulgated in the public interest and that private advantage can not be permitted to dominate the thinking or actions of their administrators.

There would be no law, and certainly not fifty-three of them requiring examination to prove the qualifications of those who would hold themselves out as capable of serving the public as certified public accountants, if the only purpose of such legislation was to serve the special interests of a favored few whose vanity had prompted them to secure for themselves a special designation placing them above their fellows.

We find, however, that there are many who denounce the CPA laws as privilege legislation, as there are those who would tear down our government and business structures. It is nevertheless interesting to note that when such people get to be sufficient in numbers they invariably gather their forces within an organization

[1] This paper was presented at the annual meeting of the American Accounting Association in Memphis in September, 1948.

and immediately admit the need for control by pronouncing rules and regulations by which they measure the qualifications of others who may seek to join with them. By so doing they accept the premise that something more than mere desire is required before a person can be admitted to be satisfactory for a special purpose. Thus, by indirection, they approve the state's motive for protecting its citizens in prescribing restrictions on those who would be certified public accountants.

Probably this sort of pressure is given more consideration than it deserves, but we are living in a period when right does not always prevail and we must not only be vigilant but ever more certain that we are not vulnerable.

If we are convinced that the purpose of our state CPA laws is to protect the public against those who may not be qualified to serve its best interests, then we must consider whether these laws are administered so that their purposes are accomplished.

Here again we find a variety of opinions. Aspirants who are unable to meet the examination requirements frequently attribute their failures to favoritism, or an intentional setting of the level at a point too difficult to permit passing. On the other hand, business interests often are disturbed when they encounter a certified practitioner whose abilities are below what they are led to believe should be found in a person who is permitted by law to offer services of the nature expected of one who has qualified as a certified public accountant. The less informed public, and this often includes some legislators, on becoming acquainted with the plaints of these dissatisfied, look to the administrators for an accounting of their stewardship.

The administration of the various state laws is vested in members of the profession who have qualified as CPAs. It is their responsibility to carry out the statutory provisions in a manner which will best serve the intent of the legislation. If the regulations which are set forth are too strict many will complain that these men, who are themselves certified, close the doors on applicants so as to avoid competition in their personal business operations. If the requirements are eased, the business public would have cause to complain that men who are not prepared by education and experience were being foisted upon it as qualified to render a service in which it placed great confidence and whose weaknesses conceivably might undermine its own financial structures. Further, inasmuch as the most valuable asset of the CPA is his reputation for ability to satisfy the requirements of his clients, he, too, could very well object to any simplification of the examination on the grounds that the ability of the poorest practitioner is frequently accepted as a measure of the competency of the profession.

To satisfy these conflicting viewpoints is the task of the CPA examiners in the various states and of the board of examiners of the American Institute of Accountants which prepares the uniform examination that has been adopted by all but two of the state boards. This voluntary acceptance of the uniform examination by the various state boards which are charged with the responsibility of conducting an examination under their state laws has been gradual, two states having decided to use it as their own only during the past year. Soon, we hope, the two remaining states which continue to prepare their own examinations will find a way to make use of the uniform examination. Then, at least, no one can complain that any candidate has a more, or less, difficult opportunity to pass due to the composition of the examination.

It follows that a uniform examination, adopted by all state boards, becomes the hall-mark of the profession. It measures the competency of an individual to prac-

tice public accounting as a CPA, and meeting its requirements marks the successful candidate with a stamp of approval for service to the public. Treating it lightly would be an unpardonable offense against both the public and the profession and would leave for the candidate a mere bauble as a reward for his accomplishment.

Because of the implications which lie in the assignment to prepare an examination which will fulfill the obligations to issue the CPA certificate to all and yet only qualified candidates, the work of the board of examiners of the Institute has grown to great importance. Its members must have a background of professional experience which permits them to know the requirements of the public, yet they must appreciate that a written examination is not in all cases a fair test of a man's inherent competency eventually to become one of the better practitioners of the art of public accounting.

In their endeavors to produce an examination that is fair to all parties of interest, the board has continually sought the advice and assistance of members of the profession and of instructors in the educational fields of accounting. In addition the candidates have been questioned to secure their views on the reasonableness of the testing. Though humanly sensible to criticism, the board nevertheless carefully considers all suggestions and studies the many attacks made upon its position. In fact it invites its critics to help improve its product. Disappointingly often, however, the response to such invitations results either in nothing at all, or little more than something similar to the story of the fellow who had been chiding an artist about his work and, upon being asked if he could paint a picture, answered, "No, and I can't lay an egg, but I can smell a bad one."

Careful study of all that has been said and written about the CPA examination convinces us that the business public and the profession would probably be better satisfied if all candidates were carefully screened and tested at a level which would disclose aptitudes for a well-rounded accounting service to the business client. The difficulty, if there is one, probably lies in our attempts to satisfy that part of the public which has no close acquaintance with public accounting, or legislators who may be inclined to champion the cause of their seemingly down-trodden constituents, whose smattering of accounting techniques and practice experience makes them ineligible to become candidates or causes them to be failures after many trials.

Certainly, we can agree that it would not be in the public interest to deteriorate the CPA service offered and relied upon during the past fifty years in order that the selfish interests of a relatively small number of all of our people might be satisfied. On the other hand, we must at all times be certain that the requirements which we set forth are in truth as fair as possible, and that we are not closing the doors on qualified seekers after the certificate by taking advantage of our positions as examiners in a manner which would in turn be serving even a more selfish interest than that evinced by those who choose to differ with us.

In general, it would appear that the CPA examiners can be expected to do no more than the best that has been suggested by even their most competent critics, always having in mind that the primary purpose of the laws under which they perform was to protect the public against incompetent practitioners.

Though we are fully informed that what is expected of us is that those to whom we issue a certificate should have the qualities of a capable practitioner, we are aware that there is a strong force of opinion, likely well-founded, that the examination for the most part is a better test of the

student accountant. This does not set up the objection that a CPA should not be well educated in the theory of accounts, but it does point up the known fact than many good students have no aptitude for the vicissitudes of public practice.

Most likely every examiner would prefer to have the authority to give some weight to a candidate's personality, his character, and the abilities he has demonstrated in actual business practice. However this would introduce the element of personal opinion, which is now as nearly as possible removed from the examining and grading processes, and would probably be the cause for more vociferous claims of favoritism and selection than are now encountered. There seems to be no alternative to a written examination and we must continue to strive for perfection within this area.

If we were to picture the ideal candidate for the CPA certificate, we would probably envision a man who has been educated at the college level with an accounting major and, in conjunction therewith or subsequent thereto, has had at least two full years of preparation in the requirements of public practice on a case-study basis, either at school or under an apprentice arrangement on the staff of a firm of public accountants which has itself been qualified by some measurement to offer such employment.

If all candidates were of this ideal type there would probably be little or no problem such as that with which we are now dealing. It may be that time and changing attitudes will bring about such a situation. If so, the public, the profession and the candidate will be better served.

However, our problem currently centers in prevailing conditions. We find that even these are not too bad if we look at the whole picture rather than become disturbed on learning that an average of only twenty per cent are successful in each examination. State board statistics disclose that about sixty per cent of all candidates eventually pass, even though they may have to take several examinations before doing so. The forty per cent balance is composed of a relative few who are completely incapable, some who become discouraged and will not persevere in their preparation, and many who stop trying because they secure employment in some field other than higher accountancy.

This candidate experience of success with the examination is probably outstandingly good when considered in the light of the law requirements for education and training. Only one state insists on a college education as a prerequisite, some have no public practice experience requirement, while there are others which require no such experience and no education beyond high school. Upon consideration of these minimum pre-examination conditions it could be claimed that the passing experience in the examination proves that it is more favorable to the candidate than it is to the public which is to be served or to the profession which has its reputation to protect.

If there must be improvement in the situation as it relates to more adequate preparation in the public and professional interest, the responsibility for such accomplishment rests with the interested public. The profession has already sponsored regulation of practice as a desirable method of meeting this condition. However, it has met resistance within its own ranks because the necessary legislation embodies the recognition, through registration, of public accountants who are now permitted to practice without any control or previously demonstrated ability to serve the public as accounting practitioners. This latter group has also opposed such legislation because it proposes to limit their number to those now so engaged and does not give them equal standing with CPA's

who have passed an examination. Because it appears to the uninitiated to be self-serving, this proposed legislation is also viewed with suspicion by legislators.

Though there are many who disagree with me, I am convinced that the proposed bill would be a good remedy for a condition that is becoming increasingly bad, for, in due time and if properly administered, the requirement for examination of all those who wished to engage in public accounting would make adequate preparation a must, and would insure a better quality of service and stronger controls in the public interest. It appears that we will achieve this goal, however, only if the business public sets up a strong demand for enactment of some such legislation.

In the meantime we must preserve the benefits of progress that have been achieved in the past fifty years, while we look forward hopefully to a better future.

In conclusion, I wish I were capable of convincing each one of you who is engaged in preparing men for a career in accounting, that we examiners are conscientiously endeavoring fairly to test these men who aspire to become certified public accountants.

Because we know that your interest in your students continues into their after-life, we earnestly solicit your aid in the preparation and administration of an examination which will be fair to them as well as to the public and the profession of which you, too, are an integral part.

MEMBER PLACEMENT SERVICE

Vacancies Reported

SOUTHERN UNIVERSITY, wishes to make contacts with individuals qualified to teach cost accounting or introductory course. Rank and salary depend on qualifications. (U-601)

EASTERN UNIVERSITY, wishes to make contacts with individuals qualified to teach accounting as instructors, assistant professor or, possibly, associate professor. Salary commensurate with rank. Inquiries relating to graduate assistantships in accounting are also invited. (U-602)

Teachers Available

ACCOUNTING, ECONOMICS, BUSINESS ADMINISTRATION: man, 43, married; Ph.D., 20 years of college and university teaching experience. Now full professor in accredited Eastern institution. Wife, 41, Ph.D., with 15 years teaching experience in secondary education, psychology, and commercial teacher training is professor in same institution. (M-201)

BASIC ACCOUNTING, COST ACCOUNTING, BUDGETING: man with broad accounting experience desires position in Southwest. (M-202)

ACCOUNTING, FINANCE, ECONOMICS: man, 42. A.B., A.M. and three years additional graduate work. Instructor and lecturer 9 years at 2 major state universities. 4 years head of accounting department (private school). 4 years as corporation comptroller and secretary-treasurer. (M-203)

Letters in reference to announcements published under key numbers should be sent to Clete Chizek, Secretary-Treasurer of the Association for forwarding to the persons concerned.

THE CPA EXAMINATION[1]

HALE L. NEWCOMER

INTRODUCTION

IN JANUARY, 1947, the Board of Examiners of the American Institute of Accountants requested the appointment of a committee of the American Accounting Association to survey the board's examination procedures, the content of the Uniform CPA examinations, timings, weightings, grading, and any other items which the committee deemed pertinent. Such a committee has been functioning the past year. The committee is not yet in a position to render a formal report, and the remarks and opinions in this paper should not be considered necessarily representative of committee consensus. Nevertheless, the speaker has not hesitated to draw upon the ideas and research of members of the Committee on the Uniform CPA Examination or on the ideas and research of others.

Your committee to date has carried forward its work by means of individual assignments and correspondence with other committee members. In June, 1948, the committee chairman and one other representative from the committee met in New York with several members of the Institute's board for the purpose of discussing the board's problems personally and to review the procedures of grading—the May, 1948, examination papers being processed by graders at that time. The two committee members left these conferences with the opinion that the breadth and depth of the problems and factors involved in examination of candidates warranted a continuance of an Association committee to maintain contact with the board of examiners and to cooperate with it in any way desirable and feasible.

At this meeting the speaker wishes to consider some aspects of the Uniform CPA examination under the heads of (1) Purpose, (2) Attainment of the Purpose, and (3) Grading and Results.

PURPOSE

Mr. Henry E. Mendes, past-chairman of the Board of Examiners of the American Institute of Accountants, has stated the purpose as follows: "Broadly speaking, the purpose of the CPA examinations is to provide adequate tests of the candidate's knowledge in certain basic, essential subjects relating to accountancy."[2] And again,

> . . . it might be well to indicate and emphasize that the principal purpose of the examinations is not to determine whether candidates have achieved accounting ability commensurate with that of leaders in the profession, but that the board of examiners, and presumably the various boards, are willing to admit men to the ranks of the profession on the basis of a somewhat lesser degree of development. In other words, in setting examinations the boards are attempting to obtain information as a basis of judgment as to the competency of candidates—to satisfy themselves that candidates have the qualifications to do what the public will expect of them as certified public accountants. . . . This implies, of course, that the examinations should be pitched at a level in which the public interest would be best served and which, in the final analysis, is the fundamental justification for CPA legislation.[3]

It would seem, then, that the CPA examination is a test of, or measure of, attainment by the candidate. With proper standards it should then serve as a protective screen for the benefit of the public. If adequate to serve as such a protec-

[1] This paper was presented at the annual meeting of the American Accounting Association in Memphis in September, 1948.

[2] "Form and Content of CPA Examinations," *New Developments in Accounting*, (The American Institute of Accountants, 1946), p. 122.

[3] *Ibid.*, p. 126.

tion it should at one and the same time strengthen the profession generally through admission only of those properly qualified.

At what level should the examination be set to attain the principal purposes mentioned? It has been generally accepted that the level should be that which will test the candidate at the level of the senior accountant. It seems generally agreed that it should not be set for the assistant, or junior accountant so-called, and Mr. Mendes stated "Candidates do not have to be possessed, necessarily, of the abilities of the leaders of the profession but only sufficient ability to meet the average demands."[4] And further "It has been the fixed policy of the board of examiners to develop uniform examinations at the level of the advanced semi-senior or beginning senior."[5]

The speaker has seen but one attempt to classify public accountants by occupational levels, with related duties and necessary or desirable qualifications. There appears to be no real uniformity in level classifications and terminology among accounting firms and, as a matter of fact, there are no sharply distinguishable lines of demarcation between assistant or junior, semi-senior, senior, in-charge accountant, supervising senior, and so on. Until the semi-senior and senior categories are well defined might it not be better to start with the premise that the purpose of the CPA examination generally is to determine those individuals qualified to practice on their own accounts as Certified Public Accountants in a medium-sized community? It would then be one of the tasks of the board of examiners and the Institute's research department to determine those situations most commonly faced by such accountants and evolve examinations to test candidates adequately in accordance with occupational demands. Proper ingredients determined on some such basis and incorporated into the examination would lend a much greater aspect of objectivity to the test. It no doubt may be assumed that the desire is to obtain professional quality, not quantity.

[4] *Ibid.*, p. 5.
[5] *Ibid.*

ATTAINMENT OF THE PURPOSE

While most persons are likely to think of attainment in terms of the written examination there is a very important prerequisite, or group of prerequisites, set by governing bodies—the entrance requirements. One may divide these requirements into two primary groups—education and experience—although other statutory or regulatory requirements of age, citizenship, and other qualifications may be present.

The usual educational requirement is four years of high school or the equivalent. New York and several other states require some education at the collegiate level, and the American Institute of Accountants has taken the position that a college education is desirable for those who enter the profession. A committee of the New York State Society of CPA's in a report dated May 22, 1947, stated

> It would appear that the educational subjects in which a prospective professional accountant is to be trained in the schools approved by the State should be set down with considerable particularity and when so set down the professional examinations set by the Board of CPA Examiners should be based upon the level of this training.[6]
> . . . in order to raise our professional education to the level of Engineering, Law, Medicine, and other professions, we should now be making plans to support the establishment of separate schools of accountancy comparable to those schools which train for entrance into the other professions.[7]

[6] Report of Joint Committee on Syllabus, Accounting Education and Content of CPA Examinations to the Committee on Education of the New York State Society of Certified Public Accountants, May 22, 1947, p. 4.
[7] *Ibid.*

In its summary the committee concludes that only education, in accordance with certain recommendations made, can accomplish the desired end of infusing into the professional ranks as new blood the type of individuals who should become practitioners of tomorrow. "The newcomers in the profession will be men on whom will rest the responsibility for improving and expanding the services which the profession must be qualified to give to the increasingly complex economic and social life of the future."[8]

In some statistics presented by Norman Lee Burton, then education director, American Institute of Accountants, in a paper read at the sixtieth annual meeting of the American Institute in 1947, the modal groups for those successful in the examination on the first attempt were those in the age bracket 25–29 years and those with a college education with an accounting major.[9] Such an array can be misleading if for no other reason than that the various groups did not contain equal numbers of candidates, but nevertheless the successes in the younger and in the more highly educated groups was striking. In the same tabulation, of those passing auditing on the first attempt, 105 had no public accounting experience, whereas 196 had one or more years; of those successful in accounting practice on the first trial, 101 had no public accounting experience, and 140 had one or more years. The value of experience cannot be denied, yet the 30 per cent or 40 per cent of successful candidates without such experience is material. In the same paper Mr. Burton analyzed the backgrounds of the 92 candidates who passed all four parts of the examination at the first attempt. He stated "If there is any moral to be derived from these data, it would seem to point to the importance of youth and education as factors in passing the CPA examinations, with public accounting experience as of secondary significance."[10]

In the Accounting Exchange department of the ACCOUNTING REVIEW of January, 1945, A. C. Littleton wrote

> People may wonder what there is in a few years of accounting experience to educate a man for a technical accounting examination. Could three years of work, mostly with mechanical details as a junior assistant, do much to build up competence for solving CPA problems? . . . It surely cannot be that the mere passage of time in certain surroundings constitutes satisfactory experience for admission to an examination. If a limited experience is made the principal basis of admission to a knowledge test, and if that experience does not of itself contribute reasonably to that knowledge, there is a serious inconsistency somewhere in many CPA laws . . . . If a limited experience is required not because of its educational features, is it then required as a protection to the public, as a hospital internship is required subsequent to a college degree in medicine? But, without a requirement of prior accounting education, this required experience in accounting comes presumably at the beginning of accounting knowledge. How then can it protect the public?[11]

The Form of Regulatory Public Accounting Bill approved by the Institute's committee on state legislation in April, 1945, proposes college graduation with specified course content and two years of experience with a gradation to high school graduation and six years experience. This is eminently sound, for since knowledge is the chief prerequisite why should not the emphasis on the experience and education elements be reversed with perhaps both a higher educational requirement than is usual at present and an experience requirement, but permissive substitution of additional experience for some otherwise required education? Or why not, with some education required at the collegiate level, grant

[8] *Ibid.*, p. 15.

[9] "Basic Information Concerning the Uniform CPA Examination," *Challenges to the Accounting Profession.* (American Institute of Accountants, 1947), p. 76.

[10] *Ibid.*, p. 73.

[11] *Accounting Review*, Vol. XX, No. 1 (January, 1945), p. 107.

admission to the examination and, as at least one state (Illinois) does, license for practice only after an experience requirement is met; or, as in other sovereign units, withhold the actual certificate until satisfactory experience is acquired?

Although two primary groups—education and experience—were mentioned, a third may be introduced, that is, the preliminary examination. The idea is not new—indeed, the practice in one form or another is not new. For many years the chartered accountant examinations have been given in sections, passage of one being required for the privilege of sitting for the next. Although in the United States reference is not made to preliminary, intermediate, or final examinations, in practice the states and territories approach very close to these. The chartered accountant preliminary examination includes coverage of grammar, composition, arithmetic, history, geometry, etc.; the CPA examination achieves practically the same result by requiring a high school education or better before sitting. Some state boards condition candidates who fail in one or more subjects and thereafter require the candidate to repeat only those in which he was conditioned. Some boards permit the candidate to sit for certain parts of the examination before meeting the experience requirement. These policies in effect recognize a type of intermediate examination although not formalized as such. They all have characteristics of a type of pre-examination which is meeting with favor in some quarters. The speaker wishes to cite a few proposals, for the high percentage of failures on examinations may eventually necessitate a more thorough screening of those desirous of entering the profession.

In the paper to which reference was made above, Mr. Mendes suggests for those without satisfactory experience a preliminary examination of three parts: commercial law, theory of accounts, and theory of auditing and economics; this is to be followed, after experience has been acquired, with an examination of three additional parts: two on practical accounting and one on practical auditing.[12] A. C. Littleton[13] has suggested one division, with an educational but no experience requirement, composed of two parts on accounting theory and practice and one part on commercial Law. This would be followed by another division, with an experience requirement, composed of two half-days of auditing theory and practice separated by a half-day on administrative law and finance. One immediately discerns a conflict of ideas in compartmentalization—Mr. Mendes would require experience before the writing on practical accounting, Mr. Littleton would not. Mr. Littleton supports his grouping in part by comparing the results of four examinations in Illinois (which has no experience requirement) with the results of grading as published by the American Institute for the same examinations. In each examination a higher percentage of candidates passed the accounting theory and practice in Illinois than of those graded by the Institute; the reverse was true for auditing.

	May 1941	*Nov. 1941*	*May 1942*	*Nov. 1942*
		Theory and Practice		
Illinois	23.2%	59.9%	35.8%	40.7%
Institute	18.3	31.8	34.2	22.8
		Auditing		
Illinois	18.9%	33.4%	15.3%	20.9%
Institute	53.5	45.2	36.8	52.3

The figures seem to suggest (a) that problems are well adapted to private study, coaching, or classroom use in preparation for examinations and, (b) that auditing can best be learned in conjunction with experience in making audits . . . . A strict requirement of experience as a basis for admission to the one and only examination is quite illogical as soon as practical experience is no longer the only way of successfully preparing to

[12] "Form and Content of CPA Examination," p. 134.

[13] "Examinations in Auditing," Accounting Review, Vol. XVIII, No. 4 (October, 1943), pp. 315f.

pass the examination. Practical experience is more properly a rule for admission to public practice than an avenue of admission to an examination. But experience as a prerequisite can still be justified if applied to an appropriate part of the tests for admission to public practice.

The report of the committee of the New York State Society referred to above recommends a preliminary examination with half-day sessions on principles of accounting, principles and technique of auditing, and business and accounting law, and two half-day sessions on accounting problems. The following excerpt from the report supports Mr. Littleton's position on accounting problems:

> . . . the techniques required for passing the Practical Accounting examination are better acquired in the class room than in the field of practice. It is the conviction of your Committee that the candidate is better prepared to write the present examination in Practical Accounting immediately upon completion of his academic course than he is after having met the new three-year experience requirement, as is the present arrangement.[14]

The final examination would be given after three years of diversified public accounting experience. The committee believes

> the scope and content of the final examination (two half-day sessions) should be such as to test the candidate's practical knowledge of the profession, its practice, its problems, its public aspects, and its ethical standards. It should also test his knowledge of the organization of the public accountant's office, the auditing methods applied in practice, relations with staff, contractual and other relations with clients, appraisal of client's system of accounts as to internal check and the effect of this on the program of audit . . . such an examination would also serve as a rating device for the character of the experience which the candidate has received during his three-year apprenticeship.[15]

As educational requirements are increased it might even be feasible in the future to dispense with the examination in commercial law as it is now set and substitute a special section on taxation and statistics, or divide the CPA examination merely into a preliminary covering theory and practice of accounting and a final covering theory and practice of auditing.

Time limits will not permit a full discussion of the written examination, but the speaker would like to consider several troublesome aspects and mention others to which the Committee on the Uniform CPA Examination is giving attention. The usual examination includes sessions on auditing, commercial law, accounting theory, and accounting practice, although a few states require coverage of another subject, such as economics. At present the consensus of your committee is that the two and one half days allowed for the usual subjects is adequate, although there is some sentiment favoring a special session on taxes or statistics.

Whatever may eventually be the breadth of the examination, the desire is to determine those best qualified to serve the public as Certified Public Accountants, and the examination should be such as to enable the examiners to judge fairly and adequately the degree of competence and the professional attitude of the candidate. In view of the increasingly important role of the accountant in our economic and social world, one may well raise the point as to whether questions aimed toward the determination of factual and technical knowledge only, or questions aimed toward the determination of ability to analyze, coordinate, think, and exercise judgment, should predominate. Undoubtedly both should be included but is it not logical to assume that as more technical education is required for entrance fewer questions need be included dealing solely or primarily with factual and technical knowledge?

At least until entrance requirements have become more uniform, the speaker

[14] "Report of Joint Committee on Syllabis . . . ", p. 12.
[15] *Ibid.*, pp. 12, 13.

is of the opinion the subject matter covered in a given part of the examination could well be grouped into a portion extremely basic and essential to the day-by-day practice of any accountant and a portion less essential even though desirable to know. The first portion might be described as a core of knowledge upon which every candidate should be examined; the second portion of fringe material might be thought of as cyclical in that candidates may and will find questions or problems from this area in alternation or rotation about the core.

Perhaps past boards *have* done this consciously or unconsciously. In an analysis of accounting theory and practice prepared several years ago by the speaker, it was found that during the period 1922–1926 the leaders in terms of points allotted were in the topics of general statements, actuarial, theory and general questions, corporations, cost, and special statements (exclusive of consolidated statements). Fifteen years later, 1937–1941, the order was general statements, fund accounting, cost, consolidated statements, partnerships, and so on down the line. In intervening periods emphasis varied but generally the leaders remained about the same with a shifting in position only. A thorough knowledge of from eight to ten such subjects would give a candidate an excellent chance to pass the examination. If such core and cyclical material were decided upon, the board would have to decide also the relative weights as 60–40, 75–25, or possibly 50–50, on the assumption that candidates will know in general what 50 per cent of the questions will be. If such a decision on nature of material were reached, it might be well for the board to prepare a syllabus stating, among other things, the nature of the core material.

Why then is the percentage of failures in this, i.e., the practical accounting, part of the examination so high? Surely any well-schooled and well-reviewed candidate knows he is going to be quizzed on the subjects mentioned above. Is it the time factor? The board of examiners has made a sincere effort to tailor the examination to the time available, and your committee feels that it has succeeded. Is it inadequate preparation or inaptitude? These undoubtedly contribute to the failures, and it is probably from individuals with these shortcomings that the loudest cries of lack of time come. Is it examination pressure? Is it because of the wording or setting of problems? Is it inability to express oneself? Is it specialized field problems and questions? Is it grading? No one seems to have the answer and yet the results of grading are disturbing. Fluctuations in the percentage of passing candidates have been violent, as witness the results of nine examinations from November, 1943, to November, 1947, inclusive.

Percentage of Passing Candidates in the Examinations from November, 1943, to November, 1947, Inclusive

	Nov. 1943	*May 1944*	*Nov. 1944*	*May 1945*	*Nov. 1945*	*May 1946*	*Nov. 1946*	*May 1947*	*Nov. 1947*
Auditing	64.5	66.0	60.5	24.4	46.4	41.6	28.6	30.5	45.4
Law	49.2	48.5	46.6	26.7	39.3	53.1	51.8	44.7	32.5
Theory	67.3	68.4	78.3	66.2	33.6	61.7	53.1	81.2	43.0
Practice	9.8	10.2	13.9	12.8	29.8	40.1	23.5	19.8	25.2

In auditing, successes varied between 24.4 per cent and 66.0 per cent; in law, successes varied between 26.7 per cent and 53.1 per cent; in theory of accounts, the variation was from 33.6 per cent to 81.2

per cent; and in practical accounting, the extremes were 9.8 per cent and 40.1 per cent.

These fluctuations are of concern to everyone, including the board of examiners. It hardly seems reasonable that the quality of candidates would vary so much within a six-months period that in May, 1946, 40.1 per cent passed practical accounting and in November, 1946, only 23.5 per cent passed. In May of the preceding year only 12.8 per cent were successful, whereas six months later 29.8 per cent passed. This would lead one to the conclusion that somehow, some way, the examinations, or grading, are at fault—always assuming more uniform results are desirable.

In an attempt to obtain a background for consideration of this problem, your committee has reviewed the board's procedures and grading involved in the examination. At present the sources for problems and questions include state boards, public accountants and their firms, paid employees, a subcommittee of the board, and educators. The sources are none too prolific and the board would like to remedy this situation. Questions are reviewed by the board along with model solutions and turned over to a subcommittee for polishing and testing with so-called "guinea pig" pseudo-candidates. Careful consideration is given to the nature of subject matter, the statement and wording of question, weighting, and timing.

Numerous points have been raised concerning the form and content of questions and these points are under consideration by the board and your Committee on the Uniform CPA examination. What, for example, is the relative value of long and short problems? Which is fairer to the candidate; which gives the examiner a better concept of the ability of the candidate? Should one afternoon be devoted to say two long problems and one afternoon to more numerous short problems? Perhaps this is the answer, as a wider coverage of subjects would be possible and a comparison of a candidate's grades on the two sessions could readily be made. Should objective type questions be used in spite of inherent dangers? What is the place of the essay type question? Much criticism has been made by public accounting firms of the inability of employees to express themselves clearly and understandably in their mother tongue. The speaker believes that a testing of this ability is proper in the CPA examination and that it is feasible to incorporate several questions in theory, auditing, and law for which half the weight attached to the question would be for use of English.

Bitter comment has been made concerning questions in specialized fields such as fund accounting, brokerage, banking, utilities, etc. Just where core material should end and cyclical material begin is moot, but once determined the use of optional questions for the cyclical or fringe portion of the examination might well be considered. This, perhaps, would be more fair to the candidate and still enable him to demonstrate his breadth of knowledge. Some have complained concerning the incorporation of questions on current topics or on current literature or releases. It seems desirable to learn the depth of accounting interest of the candidate as expressed in his "keeping up to date" and the complaint can only be justified if the source material is very recent or obscure.

GRADING

No doubt some believe that the key to all difficulties lies in the grading. All educators have experienced the headaches of question preparation and grading. In a professional examination such as this one, grading must above all else be fair and impartial. In American Institute procedure, graders do not know the names of

candidates; no one grader grades all parts of the paper; the results are subject to review by the grader in charge of that section or part.

Institute graders are well enough compensated that properly qualified persons can be obtained. Graders should be chosen on the basis of grading experience and equable temperament; a background which includes teaching experience would be beneficial. Graders should and do solve the questions assigned to them; the suggested or guide solutions and weights should then be reviewed carefully with them and in this process the board should be especially active. The board should approve and accept full responsibility for final standards of weighting and grading. Guide solutions should be checked against authoritative or semi-authoritative releases by the American Institute or other bodies, and complete consistency maintained in answers to different questions.

Constant and diligent attention must be paid by the board to standards of content and grading, for the examination should be not only uniform with respect to different states and territories but should be reasonably uniform in standards from one year to another.

CONCLUSION

Examiners have a tremendous obligation and responsibility to the profession, the states and territories delegating duties to them, and to the candidate. The approach of the examiners should be objective; it is their responsibility to determine the standards set by examination and grading. Educators may help in construction and arrayal of data, timing, weighting, and suggestions as to grading procedures and techniques. Educators may and should hold themselves ready to criticize content, especially with regard to overemphasis, too detailed specialization not of everyday or disciplinary use, and presentation of material to candidates.

The American Accounting Association can help the board in a practical and timely way. The speaker is suggesting a special or standing committee on the uniform CPA examination to cooperate with the board of the Institute. One of the chief functions could be to serve as a collecting and clearing agency for problems and questions suitable for the CPA examination. The examiners desire to maintain a stockpile sufficient to provide material for several examinations. The greater the number of questions on hand the easier is the task of the board in preparing examinations far enough in advance to allow for adequate pretesting and polishing. Who, other than professional educators, should be better qualified to construct proper examination material? This same committee might, if the board so desires, render a real service by reviewing the examinations before final distribution. In this manner the American Accounting Association could further contribute to the welfare of the accounting profession.

EXCERPTS FROM THE REPORT ON THE UNIFORM CPA EXAMINATION[1]

HALE L. NEWCOMER, CHAIRMAN

FOREWORD

THE COMMITTEE on the Uniform CPA Examination was appointed February 28, 1948, in response to a request in 1947 from the Board of Examiners of the American Institute of Accountants. The board, through Mr. John L. Carey, suggested the appointment of an Association committee to "undertake a study of the examinations of recent years, with a view to suggestions which might improve future examinations." The commitment from President Leland was interpreted broadly to include coverage of the board's examination procedures, the content of the uniform CPA examinations, timings, weightings, grading, and any other items which the committee might deem pertinent.

As a premise the committee was willing to accept the statement of Mr. Henry E. Mendes, past-chairman of the Board of Examiners, concerning the purpose of the examination as follows: "Broadly speaking, the purpose of the CPA examinations is to provide adequate tests of the candidate's knowledge in certain basic, essential subjects relating to accountancy."[2] And further "It has been the fixed policy of the board of examiners to develop uniform examinations at the level of the advanced semi-senior or beginning senior."[3]

It has been generally accepted that to attain the above purpose the level of the examination should be that which will test the candidate at the level of senior accountant. As level or grade classifications are flexible the committee believed it might well work from the premise that the purpose of the CPA examination generally is to determine those individuals qualified to practice on their own accounts as certified public accountants in a medium sized community. Consequently, an important task of the board and others would be the determination of those situations most commonly faced by such accountants and to include in the examinations questions which would test candidates adequately in accordance with occupational demands.

Whatever may eventually be the breadth of the examination, the desire is to determine those best qualified to serve the public as certified public accountants and the examination should be such as to enable the examiners to judge fairly and adequately the degree of competence and the professional attitude of the candidate. In view of the increasingly important role of the accountant in our economic and social world, one may well raise the point as to whether questions aimed toward the determination of factual and technical knowledge only, or questions aimed toward the determination of ability to analyze, coordinate, think, and exercise judgment, should predominate. While undoubtedly both should be included, as educational entrance requirements are raised the committee feels the latter type should be given greater emphasis.

ENTRANCE REQUIREMENTS

Entrance requirements may be divided into two primary groups—education and experience. The usual educational re-

[1] This report was prepared by the following committee: Hale L. Newcomer, Chairman, C. L. Kelly, Arthur D. Maxwell, Herbert E. Miller, J. Leonard Penny, Ralph C. Russell and Howard F. Stettler.

[2] "Form and Content of CPA Examinations," *New Developments in Accounting* (The American Institute of Accountants, 1946), p. 122.

[3] *Ibid.*, p. 126.

quirement is four years of high school or the equivalent. The trend at present is definitely toward a higher educational prerequisite and the committee believes this movement is sound in that it tends to raise the professional education of the accountant towards the levels required in other professions. At the same time it should infuse into the professional ranks as new blood the type of individuals who should become practitioners in the complex economy of today and tomorrow.

Therefore your committee concludes that the educational requirement goal to be attained is graduation from a college or university recognized by the state board and perhaps a refinement of this requirement in the language of Section 3 of the Form of Regulatory Public Accounting Bill proposed by the Institute's Committee on State Legislation (April, 1945) as follows: "and who has completed thirty or more semester hours or the equivalent thereof in the study of accounting, business law, economics and finance, of which at least twenty semester hours or the equivalent thereof shall be in the study of accounting." Furthermore, the committee feels that since it is rather generally accepted that the candidate is better prepared to write the examination immediately upon completion of his academic work, he should be entitled to examination immediately upon such completion. Until this goal has been attained, up to six years in practice as a public accountant, or in the employ of a public accountant or certified public accountant might be accepted in lieu of an academic educational requirement. The committee believes the right to practice or a licensing feature is something quite separate and distinct from the right to demonstrate one's ability by writing the CPA examination successfully. There is a considerable body of opinion in favor of issuance of the CPA certificate immediately upon successful completion of the examination (as in Illinois). An increasing number of boards appear to favor permitting the candidate to sit for the examination before he satisfies the experience requirement but to withhold the certificate until the experience requirement is met. The committee endorses this change in regulation but believes it should be emphasized to these and other boards that withholding the certificate until an experience requirement is satisfied is making the CPA certificate serve both as a professional degree and a license to practice.

PRELIMINARY EXAMINATIONS

From time to time considerable discussion has developed about the idea of a preliminary examination. The very large number of candidates in some states and the inadequacy of the preparation or lack of ability of many of these candidates has fostered the idea of such an examination. A high educational requirement operates as a screening device to some extent and may achieve about the same result as the preliminary examination. To the extent that some state boards condition certain candidates an intermediate examination is in effect recognized. Generally, the committee does not favor a screening examination.

WRITTEN EXAMINATION

Theory. It is the consensus that it is desirable to learn the depth of accounting interest of the candidate as evidenced by his "keeping up to date" and therefore it is proper to incorporate some questions on current topics, current literature, or releases of an authoritative nature. Some complaints have been made concerning such questions and the committee believes the board should avoid questions on obscure source material and perhaps on highly controversial matters unless credit is to be granted on the basis of soundness of arguments presented.

Problems or Practice. The committee has

made some analyses of recent examinations and from these and other sources arrived at several tentative conclusions. Bitter comment has been made by some candidates concerning the inclusion on the examination of questions in specialized fields such as fund accounting, brokerage, banking, utilities, etc. It has been suggested that questions of this specialized nature be deleted but the committee feels it is proper to include a sprinkling of these on an optional basis. This, it is thought, would be fair to the candidate and still enable him to demonstrate his breadth of knowledge. The committee recommends more short problems and believes there is real merit in the suggestion to devote (on a trial basis) one session to a number of short problems and one session to longer problems. This would permit a wider coverage of subjects and still permit the passing of judgment on the candidate's ability to handle the amount of detail and routine frequently involved in long problems. (Other comments under *General* below.)

Auditing. The committee believes there should be a judicious mixture of questions dealing with actual auditing procedures, cases, the theory or why or understanding of audit procedures, certificates, and professional ethics. It believes the board attempts to do this and merely wishes to urge a more uniform balancing of the material, not within a single examination necessarily, but from one examination to another. Furthermore, the committee feels strongly that heavily weighted questions tend to lower the number of passes and that questions weighted at 20, 30, or 40 points should not be posed. It believes that questions requiring a knowledge of specialized businesses should be used sparingly.

Commercial Law. Mr. Mendes has stated the purpose of the law examination "is to test the candidate's ability, not with the aim of his practicing law at any time, but to enable him to recognize a legal problem when he sees one."[4] And further, the examination in law "should be related, in so far as possible, to problems that a practicing accountant is likely to meet."[5] With respect to this portion of the examination the committee suggests

(1) That greater use of "situation type" questions be made—preferably stated in terms of an accountant and his client—presenting a greater amount of detail than has been the current practice.
(2) That definition type questions be used less frequently, in that this type of question places too great a premium on cramming and memorization as preparation for the examination with too little consequent benefit to the candidate.
(3) That greater attention be given to relating the subject-matter of questions to problems encountered by the average accountant in his practice.

General. The consensus of the committee is that the examination is of proper length and that there is no need for an additional half day on the same scope as suggested by some; that the board has succeeded reasonably well in tailoring recent examinations to the available time; that the number of problems should not be reduced; and that there is not at present a need for special sessions on economics, taxes, statistics, or other subjects. The board seems committed to the inclusion of some objective type questions on the examination and the committee raises no objection to this on a trial basis, providing the questions are not too numerous and generally are thought provoking rather than mere fact finding. The inclusion of one or more essay type questions in theory, auditing, and law is deemed feasible for the purpose of determining the ability of the candidate to express himself clearly and understandably in his mother tongue and the weighting in grading should give effect to this purpose.

To permit experimentation an adequate

[4] *Ibid.*, p. 129.
[5] *Ibid.*, p. 128.

supply of material must be at the board's disposal. The examiners desire to maintain a stockpile sufficient to provide material for several examinations. The greater the number of questions on hand the easier is the task of the board in preparing examinations far enough in advance to allow for adequate pretesting and polishing. As a possible aid to the board the committee recommends:

(1) A special or standing committee of the American Accounting Association to cooperate with the board of examiners and education director of the Institute.
(2) One of the chief functions of said committee to be to serve as a collecting and clearing agency for problems and questions suitable for the CPA examination.
(3) The committee to issue a call to teachers of accounting, and especially to those handling problem courses, to send problems and questions to the committee for possible use on CPA examinations. When the board indicates a shortage of material in any particular area specific requests should be made of qualified educators.
(4) The committee should screen from the material received any items it deems unsuitable for examination purposes, delete the names of contributors, edit, and transmit to the board.
(5) The executive Committee should allocate sufficient funds each year to permit at least two members of the committee to meet in consultation with the board in New York if that appears desirable to all parties concerned. Such consultation would be for the purpose of discussing examination material, results of testing, standards, policies, procedures, and grading results of the actual examinations as compared with "guinea pig" results. (Your committee is unwilling at this time to recommend any preaudit of an examination should the board request it. This, it believes, should be a matter of policy to be determined by the Executive Committee.)

CONCLUSION

The committee wishes to acknowledge the fullest cooperation on the part of the board of examiners of the American Institute of Accountants and especially of its chairman, Mr. J. William Hope. It believes the board has made a sincere effort to better its examinations and procedures and no better evidence is needed than the request of the board for a survey by an independent organization. The comments, opinions, suggestions, and recommendations in this report are in no way offered in a spirit of derogation or fault finding, but rather in the hope some helpful and progressive ideas are incorporated herein. It is the consensus of the committee that the breadth and depth of the problems and factors involved in examining candidates warrants a continuation of an Association committee to offer aid to the board of examiners and to cooperate with it in any way desirable and feasible. Continued cooperation between the Association and the Board would augur well for the development of better examinations and the assurance that only those properly qualified would be permitted to offer themselves to the public as certified public accountants.

THE EFFECTS OF A NATIONAL TESTING PROGRAM ON ACCOUNTING EDUCATION[1]

T. A. Budd

Last February, upon the request of Dr. Ben D. Wood, Director of the College Testing Program of the American Institute of Accountants, President Leland appointed a Test Advisory Committee of this association. The Committee includes Professor Ayars, University of Pittsburgh; Professor Boyd, University of Illinois; Professor Emblen, Montana State University; Professor Husband, Wayne University; Professor Reiner, Western Reserve University; Professor White, University of Texas; and myself as chairman. The committee was created to work with the Committee on the Selection of Personnel of the American Institute in the preparation of new tests and to act as adviser upon such matters as the Institute committee might place before it.

A second objective of the Advisory Test Committee, as indicated by President Leland, was to consider the advisability of drafting a program for the American Accounting Association designed to improve testing in the colleges, a program to be submitted to the Executive Committee for its approval or disapproval. In the matter of the first of these objectives, that of advising the Institute committee, your committee when it makes its report will state that it has completed two definite assignments for the Institute, one in connection with a new short form of Level II examination and the other in connection with the proposed fees to be charged for examination services.

Because of the widely-spread residences of the members of your committee, it has been impossible to hold meetings and discuss a program to improve testing in the colleges. The committee will proceed however to do what it can by correspondence. Possibly whatever discussion that may take place today will be helpful.

It is not my purpose to review the project of the American Institute. That has been brought to your attention on other occasions and was fully described in the Accounting Review of last January. It is rather my desire to discuss briefly the effects of any national, regional, or wide-range testing program on accounting education; for the purpose of the present discussion, a mythical program.

The project of the American Institute was designed for, and still aims toward, improved methods in the selection of personnel for public accounting firms. This is a more limited objective than I have in mind, because the important fact that only a minority of college students either aim for or finally reach the field of public accounting makes it necessary to discuss a testing program from a much broader point of view, one which would include all students of accounting without regard to their ultimate goals.

A discussion of a national, or regional, testing program must include, first, the reasons for the inauguration of such a program and whether it is a desirable thing; second, the probable results of the program once it has been established; and third, the problems that must be solved prior to its institution and later in its administration.

Some years ago a college was forced to base its decisions concerning the admission

[1] This paper was presented at the annual meeting of the American Accounting Association in Memphis in September, 1948.

of students upon the results of entrance examinations constructed, administered, and graded by the college itself. During this era a college which offered comparatively easy examinations was able to obtain a plethora of students, while a college that maintained strict standards sometimes found its quota difficult to fill. This haphazard method of controlling admissions did not always result in satisfactory academic standards and as a result there was great inequality in the reputation of the degrees awarded. Later, entrance examinations were eliminated by a goodly number of colleges and secondary school records substituted. But, it was soon realized that schools vary almost as much as individuals and that a definite admission program was necessary. Out of the chaos came the College Entrance Examination Board and other regional boards. Definite standards were established and today practically all of our colleges are quite dependent upon this examination program.

The professions, led by medicine, dentistry, and law early established qualifying examinations for practice. Later, accountancy was placed on a professional basis with the advent of the degree of Certified Public Accountant. Of more recent date, the professional designations of Chartered Life Underwriter (C.L.U.) in the life insurance field, and Chartered Property Casualty Underwriter (C.P.C.U.) in the property insurance field, have been added to the list. Each of these testing procedures has had important effects upon the standards of the vocations and upon the educational programs leading to the respective examinations.

All those programs aim to establish a professional designation after the individual has completed his formal education and has entered the area of business or professional activity. None of them aims to test the aptitude or achievement of the student during the period of his training. None of them tries to assure the individual that he is fitted for the career he has chosen before he has made considerable expenditures of time and money or before his employer has made a considerable investment in him. It may be argued that all colleges rate the students by giving them grades in their courses and that in the case of accounting, for instance, they should have some idea of their abilities from a survey of their records. This is true only within certain limits.

If all instruction in all colleges were equally efficient, if the courses of study in all colleges included the same materials with equal emphasis, and if all the grades represented standard achievement, each student could assume well in advance of his initial employment his chance of ultimate success in the field. But American educational institutions are not equally efficient, their courses of study frequently do not follow the same pattern, the grades that are given are as varied as are those who give them, and thus a student may be led to assume that he has the aptitude for and is prepared for the accounting field when actually he may not be at all.

An indication of the variability of the achievement of students from several institutions may be obtained by studying the distribution of scores made by accounting students in the Institute's Level I and Level II tests. In the Level I test, given in the Fall of 1946 in 36 colleges, the median scores for the individual colleges ranged from $91\frac{1}{2}$ to $41\frac{1}{2}$; and in the Level II test the range was from 92.3 to $49\frac{1}{2}$. In the former case only about 32 per cent of the grades in the lowest ranked college were as high as the lowest scores of the four highest ranked colleges.

Even if due allowances were made for the conditions under which the examinations were given and for the possible selection or non-selection of the students who took the examinations, the differences in

the scores were too great. This demonstrates the fact that the abilities of the students, the methods of instruction, or both, were by no means on the same plane. The results of the Level II examination showed an even more serious situation. Here the lowest ranked institution had only one student whose grade was above the median for the whole group, and 80 per cent of its students were placed in the lowest quartile of all the students in the 25 colleges. While the lowest ranking college may not be a criterion, the fact that 9 of the 25 colleges had only a few students whose grades might be considered satisfactory and demonstrating capacity for an accounting position shows the seriousness of the situation.

All of what I have said shows the necessity for some procedure whereby the student may obtain valid data upon which to plan his future career, whereby teachers of accounting may know how effective their courses of study and their instructional methods may be, and whereby employers may be able to judge accounting aptitude and accounting ability in advance of employment better than under the present haphazard methods.

It is my hope that some day there may be a testing program, national, or at least regional, in scope that will help to place accounting education on a more or less standard basis. I have no illusion that such a program may be instituted in the near future, but the sooner it is talked about the sooner will plans begin to be formulated.

The advantages of a national, regional, or over-all testing program may be summarized as follows:

1. It would act as a qualifying agency for junior positions in the accounting profession.
   a. In the field of public accounting
   b. In accounting departments of industrial and financial enterprises and in governmental departments
2. It would tend to codify accounting course and accounting curricula.
3. It would tend to standardize teaching methods.
4. It would act as a check upon instructional efficiency.
5. Provided the tests were set at several levels, it would serve as a prerequisite for entrance into accounting majors, thereby eliminating some students from the advanced course and relieving to some extent the pressure upon senior members of the various faculties.
6. It would serve to relieve the CPA Board by acting as a screen for candidates, thereby decreasing the number who would take the examinations and incidentally raising the proportion of those who would pass.

All of these advantages are important, and if a testing program resulted in even a portion of them it would be worthwhile.

On the other hand, a testing program covering a wide range would also raise some very troublesome problems. Probably the most important and most fundamental objection might be its possible tendency to restrict the scope of accounting education. Given centrally devised examinations, the results of which would be important to the students as a factor in their placement in positions and important to the colleges by virtue of competition the instruction and preparation might conceivably be pointed so directly toward the examinations that the breadth of training which is so important as a basis of future success might be sacrificed for immediate advantage. I have pointed this out in another connection and have emphasized the danger of restricting the scope of accounting education, particularly when it is directed toward the examination for the professional degree. In an address which I made before several chapters of the National Association of Cost Accountants and which was published in the ACCOUNTING REVIEW last April, I stated:

All accountants are not certified public ac-

countants and many do not aspire to be such. Many accountants are engaged in the industrial field and many practice public accounting without the official designation. But because accounting curricula are aimed at the passing of the examination, the requirements for the degree dominate the area of instruction. This leads to the important conclusion that a curriculum that has as its goal a particular examination or set of examinations tends to become restricted in its scope. The curricula of our secondary schools are patterned after the requirements of the college entrance examinations. The colleges require that a certain fixed number of credits be required for admission, and they furthermore limit these credits by a fixed schedule of subjects. The secondary schools cannot evade the issue raised by these requirements and must pattern their curricula to meet them. In addition, the contents of past examinations in a given subject result in an inclusiveness and an exclusiveness of materials. Such an arrangement is highly satisfactory to the colleges but does not foster great advancement in secondary school education.

Training, whether in accounting or in other subjects, within narrow limits is not conducive to success in the area of business enterprise. Imagine how ill-equipped a cost accountant would be if he knew only the basic elements of that subject, his training being limited to the bare tools of his trade, and he knew nothing about industrial management, financial policy, or labor relations. Or consider the handicap under which a public accountant would work if he knew nothing of the principles of corporation finance. Broad training is essential to success in all of accounting work regardless of the specialty. Important as this objection to a standard examination program may be, it nevertheless can be overcome. If the testing program is inclusive enough to force preparation in a core of subjects related to accounting in the long run it might have a broadening rather than a restrictive effect.

A second problem is that of the organization that would be necessary to administer properly a program of wide scope. First, it would be necessary to obtain the cooperation of a majority of college administrators and faculty members, and to a lesser degree the students themselves. Second, the sympathy of the public accounting profession would have to be obtained. Third, it would be necessary to publicize and sell the program to such an extent that in due course of time employers of accounting personnel would recognize the results of the examinations and give an employment advantage to students of high rank. All of this would take time and manpower.

A third and important problem is the financing of a program of such size. Fundamentally, the major financing should rest upon the shoulders of those who stand to gain the most from it, the employers and the students. No great part of the burden could be placed upon the students and it is not likely that the employers, at least immediately, would subsidize the program. Possibly some contributions would be made by business enterprises which are dependent upon the colleges for large numbers of accounting personnel, but only a minor part of the budget could be expected from this source. The cost, therefore, would have to be borne in large part by the colleges and by interested professional organizations such as the American Institute, the Controllers Institute, the National Association of Cost Accountants, and the American Accounting Association.

Coincident with the problem of financing is that of the administration of the program. This would involve a national, or regional, board which would arrange the form and contents of the examinations to be given, their distribution, and their grading. This would be no small job.

The examinations would probably include an aptitude test of some type. It would have to be decided whether to use a specially designed accounting aptitude test such as the American Institute is developing, or a test such as the Scholastic Apti-

tude Test with some adjustment as to the weight of the mathematical and verbal portions. The score of the chosen aptitude test would be used mostly for the guidance of the students and would be studied in connection with their achievements in first-year accounting. In this manner one result would be used as a check against the other.

In addition to the aptitude test, achievement tests would be offered in several parts. One might, for instance, correspond to the Level I Test of the American Institute and be arranged to test the student's knowledge of elementary accounting. The remaining tests might be constructed to test on a subject-matter basis rather than merely at an upper level. Thus, it might be decided to test in the areas of cost, auditing, industrial accounting systems, financial accounting systems, and federal taxes. Again, it might be advisable to arrange an optional test covering allied subject material taken from the student's over-all training in business administration. Such a test might include commercial law, corporation finance, investments, management, and elementary economic theory. It would be a valuable source of information to an employer by which he could gauge the breadth of the prospective employee's training for business.

Because of the size of the job to be done, and in order to limit the amount of time required of the student as well as to assure standard grading, it is probable that the examinations would be of the objective type. Although there is some doubt in the minds of a number of the teaching profession as to the effectiveness of this type of examination, nevertheless it has its uses and advantages. Since the problem type of examination would undoubtedly be used in regular course work, and because the testing program would act simply as a check upon the achievement of the student, there would seem to be no valid reason for discriminating against the objective examination.

I want to call to your attention an article written by Dr. L. L. Thurstone of the University of Chicago which appears in the current issue of *The Bulletin of the American Association of University Professors*. Dr. Thurstone is concerned with the questionable testing that is being done in our colleges and high schools. He proposes that manuals containing examination questions be prepared for each high school and elementary college subject. The manuals would contain examination questions arranged according to the conventional chapter headings of current textbooks. These manuals should contain so many questions that they could be used indefinitely. The number of questions would be so large that no harm would be done if they were to get into the hands of students.

As an example Dr. Thurstone uses a high school teacher of physics who has just completed instruction in a chapter on sound. He would turn to the manual in which the section on sound would contain several hundred questions and would choose the questions which would seem to be appropriate as to content and level of difficulty for his students.

Dr. Thurstone believes that unless national standards of certification are at stake they should not be set by an outside agency but should be adjusted to the class. Contents of courses may vary legitimately and freedom of instruction is necessary to encourage innovations in teaching.

The preparation of the manuals should be a cooperative undertaking; teachers should be encouraged to supply questions and problems. These should be edited by one or two experienced teachers with the assistance of an advisory committee.

Dr. Thurstone points out that the cost of preparing examinations in the objective form is so great that ordinarily the exam-

ination papers are numbered and great care taken to prevent their getting into the hands of students. He believes that it would be better practice to announce that every examination is public property as soon as it has been given. This, of course, could only be done if the number of questions were large.

Dr. Thurstone is more optimistic than I am with regard to the financing of the manuals. He believes that the manuals would be so widely used that the project would become self-supporting, that the schools and teachers would through their purchases create revenue enough to carry all costs.

The type of examination in the manuals would, of course, be objective and Dr. Thurstone believes the only disadvantage of this form of examination to be the time and effort to prepare the questions properly. He argues for the objective examination as a type which offers:

a. More incisive in covering material
b. Higher reliability and validity in grading
c. Greater speed in grading

I also wish to call your attention to an article which appeared in the *Pathfinder* under date of August 25, entitled "Rating the Tests." The article is critical of tests and raises the question, "Are schools being victimized by spurious tests?" The article quotes Dr. Harold A. Wrenn, Director of Admissions at Cooper Union:

> There are about 30 companies publishing educational and psychological tests. There are hundreds of these tests. Many of them are wholly meaningless. Fictitious validation of tests is foisted on a consuming public. Few tests measure what they claim to measure. The result is confusion. There ought to be some form of Bureau of Standards for tests to pick the wheat from the chaff. A group of experts should be organized to recommend format, standards for reliability, etc.

The nearest approach to the above is the Mental Measurements Yearbook[2] which contains reviews by more than 300 educators of specific tests now on the market.

The article claims that there are now 4,500 tests published every year in the United States.

The administration of a program such as this would entail a real job, but a job worth while. The problems that have been mentioned are capable of solution and the success of the program would not be beyond reasonable doubt. In any event, much of the professional service in the administration of such a program would fall, I fear, upon college faculties as a labor of love. In this, as in so many other instances, the faculties could be counted upon for more than their share of the work to be done.

It should be realized that the proposals here made are at the present time visionary that much water must flow under the bridge before accounting education in general will be ready for them, but every new phase of accounting instruction must have its growing pains and a start must be made somewhere. The idea of an over-all testing program started with the members of the American Institute; that which I have stated here is merely an enlargement of their ideas, a possible application of the testing principle to the entire body of accounting students with whom we work and in whose success we are so much interested.

Certain it is that at present we have neither educational nor instructional equality in our several institutions, and certain it is that we should pause to restudy our methods. Accounting in theory and in practice has grown by leaps and bounds, but much of our educational method has not kept pace with it and we must look forward to more coordination and less variability in our instruction. A testing program, worthy of the name is one means toward the end we should be seeking.

[2] Edited by Dr. Oscar K. Buros, Associate Professor of Education at Rutgers University.

EXPENSE AND ACCOUNTING CONCEPTS AND STANDARDS

HERMANN C. MILLER

It is always difficult to disagree with the logic of an argument presented by Professor W. A. Paton. His article published in the January 1949 issue of the ACCOUNTING REVIEW presents a devastating barrage of reductio ad absurdum, invective, and fascinating wit which may too readily be accepted by his readers. The issues at stake should be drawn clearly. Irrelevant comments and argument based upon false assumptions should be discarded before there is any disposition to repudiate the statement, *Accounting Concepts and Standards Underlying Corporate Financial Statements.*

Lifting one paragraph (5 under Expense) from the entire context Professor Paton characterizes as a "novel and almost incredible proposition" that having established a plan or program for the assignment of the cost of an asset to expense—"*made in good faith after considered judgment and after competent review, in accordance with the accepted accounting concepts and standards of the time*" the consistent and inexorable application to the ultimate end shall be made without any deviation, juggling, wavering, backsliding, or pussyfooting away from that originally adopted plan or program. (The words of the statement are: "is not subject to reversal in a later period.") Recognizing that many accountants and others would prefer to make an original estimate of the life-span of a capital asset and revise that estimate either frequently or infrequently to accord with a new estimate, it hardly is fair to charge those who prefer the consistent, steady, and unchanging application of an estimate made in accordance with the basic stipulations of "good faith," "considered judgment," "competent review," and "accepted accounting concepts and standards of the time" with "novel and almost incredible" ideas. Certainly by this time all informed persons recognize depreciation provision as an estimate. As such there is inherent in that provision the ever-present factor of error which cannot be exactly compensated by adjustment until the asset life is exhausted. Even Professor Paton's proposition that adjustment be made whenever it becomes apparent that the original estimate was erroneous, or at less frequent intervals, still requires a new (and potentially erroneous) estimate of remaining life, which in turn may, under his proposition, require additional "corrections," adjustments, changes in periodic charges, etc., again and again, until the asset no longer has usefulness. His proposal therefore, merely substitutes a new erroneous estimate for the originally erroneous estimate and at the same time destroys the comparative usefulness of statements by ever changing charges for depreciation provision. The net result would be change; but there would be no gain in accuracy, exactness of measurement of depreciation, or comparative usefulness in the resulting statements. If the 1948 statement of The American Accounting Association is to be characterized as novel and almost incredible on this count, may we have more of it!

Professor Paton's lack of enthusiasm for the proposition perhaps arises out of a desire to have the asset and related reserve for depreciation accounts reflect some sort of quantitative measurement of the "value" of a partly worn out asset. There seems to be no suggestion in the Association's statement that such accounts give a quantitative measurement of value. Rather

the statement says "The portion of recorded cost to be reported in the balance sheet is the amount assignable to future periods." In other words, the asset account reports the recorded cost, the reserve for depreciation[1] reports the portion of the recorded cost already assigned to past operations, and the difference (balance) reports the portion of the recorded cost remaining to be assigned to future operations in accordance with the plan or program originally established in good faith, after considered judgment, after competent review, and in accordance with accepted concepts and standards of the time. It is submitted here, that accounting statements so prepared do supply dependable information for the formulation of judgments. And as stated in the Association's statement under "Concluding Comments," "These judgments made in an economic setting subject to important changes can be relied upon only if such standards are adhered to consistently."

There is no denial of the application of hindsight. The statement in no place commits the accountant to past decisions and to past mistakes. It does, however, restrict the use of such hindsight so that it may not become an instrument of destruction, a plaything for the exercise of whims, fancies, and conspiracies, and a seemingly valid excuse for varying, unexplained, and unidentified bases of financial information from which the intelligent application of interpretation (including hindsight) may proceed. Nothing in the statement requires or condones a postion assumed by Professor Paton "to deny the existence of economic resources." Certainly any asset, the cost of which has been wholly charged to expense through a consistent plan or program originally established, is not to be denied existence if that asset has any residual usefulness. Indeed, the showing of its continued existence and use after the total cost has been charged to expense must be insisted upon.[2] An argument based upon any assumption that this is not permitted in the Association's statement proceeds from a false premise and as such must be characterized as pure sophistry.

Professor Paton seems determined to prove the proposition that the committees wanted to "write things off, to absorb and minimize assets and property rights." Assuming this to be true, his argument is incontrovertible. However, that assumption is so far from being sound and accurate that it appears unnecessary to reply to argument based thereon. It may be appropriate to point out, however, that Professor Paton's argument considers only the effect of premature write-off and ignores the cases where the opposite is to be found. If one were to adopt his line of attack, it could now be assumed that he would adjust the premature write-offs but would ignore the case where the write-off is insufficient at least until the date of final collapse and exhaustion of an asset occurring prior to total charge off. It is not believed that Professor Paton would take such a position but it may well be assumed that corrections or adjustments to be made subsequent to the adoption of a plan of depreciation or amortization would be more usually advocated because of premature write-off than in the case where the write-off is proceeding at too slow a rate. Somewhere in the argument there seems to have been a confusion of the over-all effect of over-and-under-absorption, a neglect for the

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[1] By whatever title it may be given.

[2] The asset recorded cost will be shown in the balance sheet. The applicable (100%) depreciation reserve will be shown in the balance sheet. Full disclosure will thus be made of the asset's continued existence and usefulness, and of the obvious fact that provision for depreciation in past periods was excessive while provision for depreciation in future periods will be understated. The Association's statement does not at any point deny the proper interpretation, explanation, or notation which might well accompany the corporate statements under such conditions.

desirability of consistent treatment period by period, a crusading spirit to accomplish frequent partial and still imperfect adjustments, and the current clamor for an ever changing accounting base moving up and down with the vicissitude of stock, commodity, money and other markets so easily summed up in the words "changing prices."

It should not be assumed that because of insistence upon the use of recorded cost as the only available objective information there is any suggestion of belief in or advocacy for the proposition that careful consideration should not be given to important changes such as may be found in price level changes and many other considerations. However, such considerations lie wholly beyond and outside of the area of basic corporate financial statements and at the same time may be said to lie within the area of managerial judgment, investment analysis, and interpretation. In the latter area, it is to be assumed that the accountant of integrity, competence and social responsibility may make a valuable contribution. The former area is exclusively a field for the accountant, while in the latter area his contribution is only contributary.

Unless Professor Paton can find better cause for criticism of the Association's statement, there is no valid reason for his conclusion that it should be repudiated.

CASE STUDIES IN INTERNAL AUDITING[1]

A. J. E. Child

To paraphrase the Institute of Internal Auditor's Statement of Responsibilities, internal auditing is a practical technique designed to accomplish the following:

1. Ascertain the degree of reliability of accounting and statistical data developed within the organization.
2. Ascertain the extent to which company assets are properly accounted for and safeguarded from losses of all kinds.
3. Ascertain the extent of compliance with established policies, plans, and procedures.
4. Review and appraise the policies and plans of the organization in the light of related data and other evidence.
5. Review and appraise the internal records and procedures of the organization in terms of their adequacy and effectiveness.
6. Review and appraise performance under the policies, plans, and procedures.

It will be realized that this is no small assignment for a staff group within a corporate organization. Such staff must be well trained and adequate in numbers. To illustrate, one corporation in this country has a budget for internal auditing of approximately one million dollars.

As illustrations of the foregoing, three groups of case studies are presented:

1. Routine internal audit functions.
2. Special assignments to determine the efficiency of an operation.
3. Special investigations of fraud and theft.

The experiences and practices utilized are for the most part drawn from our own company. Because the meat packing industry is one of the less-publicized (perhaps due to its lack of any glamour), it is necessary to give a brief description.

Our company processes and markets meat, poultry and dairy products, vegetable oils, fruits, vegetables, fish, mineral fertilizers, and the by-products of all these. The physical equipment consists of packing plants, cold storages, oil refineries, creameries, canneries, fertilizer and feed plants, leather tanneries, and wholesale warehouses, about eighty units altogether. These extend all across Canada and into some parts of the United States. The annual volume of business is about 250 million dollars.

There are special control problems in an industry of this kind:

1. Because of the wide geographical spread of the various units, supervision by remote control is necessary and complicated. The internal audit department is, therefore, regarded very much as the eyes and ears of management.
2. The management and accounting systems are highly decentralized. Down to the smallest unit, local management has wide powers of initiative and action, and all accounting records up to a general ledger are kept locally. The control of cash, receivables, and payables is local. This requires frequent and detailed audits of the smaller units, although at large plants good internal check can be operated by local management.
3. The nature of the products handled requires special safeguards against spoilage and theft. An internal auditor must constantly check the conditions of merchandise, the storage and warehousing facilities, and the effectiveness of inventory control.

The internal audit department in our company consists of ten auditors of varying degrees of experience, plus several clerical assistants. This is somewhat small for adequate coverage. At present the size of the staff is limited by the number of senior auditors available to give on-the-job training, a necessity no matter what the previous experience of a new man may have been.

[1] This paper was presented at the annual meeting of the American Accounting Association in Memphis in September, 1948.

Every corporation has its own ideas of the services its internal audit department should provide. In brief, our company wants the following:

1. The objective reporting of inefficiencies and sub-standard work, along with recommendations for correction and improvement.
2. Prevention and detection of fraud and theft, preferably prevention.

Regarding the first of these objectives, the following instructions are given to our auditors:

"In any department, determine first of all the reason for that department's existence. What is it supposed to do? Then ask yourself if, with the material it has to work with, it achieves its purpose in the shortest possible way."

ROUTINE ASSIGNMENTS

What might be called *routine assignments* include three main sections of our audit program, namely, accounts payable, accounts receivable, and inventories.

Accounts Payable

Every one of our units pays its own bills locally. Purchases of raw material and saleable merchandise are almost completely under local control. Expenditures for equipment and supplies in excess of certain amounts are subject to Head Office authorization.

The internal audit department, therefore, faces the following problems:

1. In general, it must see that no money is paid out for which we have not received full value in goods or services. More particularly, we wish to know
2. That raw materials and merchandise were bought at the market, in good condition,
3. That quantities paid for were actually received, and
4. That payments for capital and expense items were properly authorized.

As is common practice, all purchases must be initiated by a purchase requisition sent from the department requiring the goods to the Purchasing Department. The vendor's invoice, when received, must agree with the specifications on the requisition. All deliveries are made to a receiver, and the quantities shown on his report must be the same as charged by the vendor. Our method of audit is as follows:

1. The auditor examines and observes in detail the operations of the purchasing, accounts payable, and receiving departments, in order to appraise compliance with system, efficiency of personnel, and whether the present system is suited to actual conditions and requirements. At receiving points he will try particularly to determine by observation and questioning, the extent to which incoming goods are conscientiously counted, weighed, examined, and recorded.

2. All desks, files and correspondence are examined with a view to reporting on

   a. neatness and orderliness,
   b. answering of correspondence,
   c. condition of the work, to make sure that orders are not being delayed.

3. Incoming correspondence goes to the auditor for several days.

4. The files of unfilled requisitions are checked to see which vendors are late with invoices. Vendors' invoices on hand are also checked to see if there has been faulty receiving or requisitioning on our part.

5. We have both a voucher system and an accounts payable ledger system, the use of either depending on local conditions. If the latter is used, the ledgers are checked in detail for balances, adjustment, and age of accounts. Postings are tested, and vendors' statements are checked against the ledger accounts. There are always certain vendors' statements on hand; in addition, the auditor requests verification statements from a group of vendors.

6. A representative number of files of vouchers are examined in detail and checked to the controls. In his examination of the vouchers, the auditor looks for:

a. Completeness of the voucher; that is, there must be our requisition, vendor's invoice, and our receiving records. All must agree. If the delivery of goods is a complicated one, there must be on file all documents necessary to show that we received exactly what we paid for. There is no rule of thumb; the auditor must know what is required in every case.
b. The auditor passes judgment on neatness. We do not tolerate careless or untidy work at any point.
c. Complete authorization must be evidenced by the signatures on the vouchers.
d. There must be complete evidence by signatures that quantities, specifications, prices, and arithmetic have been checked. Arithmetic is tested by an audit clerk.
e. If necessary, competitive prices must be obtained.
f. Date of the voucher is noted. We do not tolerate late vouchering, and we insist on prompt payment to our vendors.

7. Besides checking ledgers and vouchers, all additions of listings and controls are checked by comptometer operators and the totals verified to the controlling accounts.

In summary, we believe that our method of internal audit relating to accounts payable is the best we can devise to guard against fraud and important errors. We do not pretend that it is very effective in preventing an arrangement between a vendor and one of our buyers to shade a price in the vendor's favor. We buy in very large quantities and it is difficult to detect a purchase that is a fraction of a cent a pound too high.

We believe that our internal audit has kept these departments operating in orderly fashion, with minimum staff, and has ensured that the work of purchasing and vouchering is always up to date.

Accounts Receivable

Every retail butcher and grocer in Canada is our customer, plus thousands of other businesses and institutions that use our products and by-products. Our salesmen blanket the country, and they collect most of the accounts. We have twenty-five sales offices, each with its own accounts receivable ledgers, which are in charge of a credit manager. The individual control of accounts is at the local office, but policy is set at Head Office, and overdue reports are sent to Head Office once a month. For the most part, the meat packing industry allows a week's credit only, and none of the large companies will allow much delinquency.

The internal audit department is confronted with the following:

1. It must verify, at widely scattered points, that the accounts due from customers are represented in the correct amounts in the ledgers.
2. Because accounts are paid to the salesmen, the auditors must be alert to the possibility of the withholding of collections.
3. The auditor must appraise the efficiency of local credit management, and of the clerical work in the accounts receivable department.
4. The accuracy of reports to Head Office must be verified.

With these requirements in mind, our auditors usually visit accounts receivable departments on a surprise basis and take possession of one or more ledgers. The accounts are checked in detail to a current trial balance, or the auditor makes his own. All accounts are proven for adjustment, and postings are tested. The age of the accounts is checked to the latest overdue report, or the auditor compiles his own overdue report if his visit is not at or near the end of the month.

The files, records, and routine of the department are closely examined for evidence of inefficiency in any way. It is our rule in accounts receivable work, that all posting and balancing must be completed each day, and the auditor reports any failure to observe this rule.

Verification statements are mailed to all the customers of certain salesmen. Usually the writing of these statements is done by

local clerical staff, but the auditor must check them to the ledgers and supervise their mailing. Occasionally an auditor will personally call on a number of customers to verify their accounts, at which time he will naturally be interested in the customers' reactions to our products and service.

After completion of the audit, the auditor's report covers:

1. His opinion of the local credit management, supported by comment on individual accounts.
2. An appraisal of the mechanical efficiency of the department and the personnel.
3. Comment on any errors or omissions found during the audit.
4. Manipulation of collections. If such a case is found, a special report is made.

The main idea, of course, is to present to the executives and the general credit manager a report on the department that will give them all the facts that they would seek if they made a personal visit.

Inventories

The extent of inventory verification by public accountants throughout the country may vary widely, but in our company there are no qualifications to the check required from the internal audit department. Every time an auditor visits one of our locations he must check the inventory completely, and at the end of the financial year a complete check is made throughout the company under the supervision of the internal audit department. Emphasis is laid on this because of the perishability of many of our products, the danger of theft, and the possibility of manipulation of inventory figures to cover operating losses. The last is a serious matter because of our policy of decentralized operations, and of our practice of weekly profit and loss statements. On occasion a department manager may think that, by inventory manipulation, he can cover up a bad week, and then regain the lost ground in the following week.

All this responsibility presupposes that our internal auditors are familiar with our products, and limits recruits for the department to men of some experience.

At branch warehouses, the auditor checks all of the inventory at one time. At large packing plants, the inventory is usually checked in sections.

Whenever possible, the auditor or auditors will do everything themselves. But, if the inventory is too large, local men are enlisted who have no connection with the inventory to be checked. They are given written instructions and are required to sign a certificate as to their check.

The method of check is to visit every room in the building and record everything found there. The inventory sheets are then priced, totaled, and compared to book records for both weight and value. The auditor always takes one or more men with him who are familiar with the inventory, to assist him in locating, moving, piling, counting, or weighing the product.

Special attention is paid to obsolete, damaged, or inferior goods.

It goes without saying that the book records will also be checked to make sure they are accurate. The auditor must also be on his guard that all product received has been vouchered and that there are no large fictitious sales just prior to his visit.

With our system of weekly results, it is often possible to check the inventory at the close of the week's business, and the book records will then be cut off in a normal way. In any case, it is not difficult, if in the middle of a week, to post purchases and sales up to the time of inventory check.

There is nothing very complicated about the auditor's report on this task. Since we handle many products subject to shrinkage there are always a number of discrepancies. The auditor reports only those he feels to

be abnormal. Where the discrepancies are abnormal, the auditor tries to determine the reasons, which may be due to clerical error, poor operating, manipulation, or theft. This is the most difficult part of the assignment, and often means hours of unrewarded work.

The auditor's report also deals with the handling of the stock, adequacy and condition of space, slow-moving lines, and condition of product.

SPECIAL ASSIGNMENTS

The first illustration in this section concerns an examination of accounts, and survey of operations, of a conversion plant of a heavy-industry corporation. The parent corporation maintains a regular internal audit department. Its program, however, did not cover this conversion plant, as its character and relationship were not permanent.

As stated in the report to the Chief Auditor, this assignment was to determine:

1. Whether the accounts of the conversion plant appear fairly to reflect all of its financial transactions since inception of its operations, and its current financial position;
2. Whether its property accountability records appear fairly to reflect the kinds and quantities of property for which it must account, and whether the quantities which the records show as on hand are, in fact on hand;
3. Whether its accounting procedures and system of general accounting control appear to be adequate, and
4. Whether the status of its affairs and the progress of its work in general appear to be satisfactory."

The audit report in this case covered forty-eight pages, but it is condensed in the following pages to show the scope, methods and results of the assignment.

The auditors were given a free hand to pursue whatever methods they considered necessary to achieve their purpose. This audit differed from a routine assignment in that the auditing department had never visited the plant before, and, because it was not included in the audit program, there was no laid-down procedure as a guide. Further, the auditors were not on familiar company ground, and therefore had to proceed with caution and tact in their examinations and conversations.

The senior in charge states that his staff

"examined the trial balance, supporting schedules and statement of contract documentation. They reviewed the accounting procedures and system of internal control, and, without making a detailed audit, examined or tested accounting, property accountability and other records in a manner and to an extent deemed necessary. In addition, inspected the physical facilities and arrangement of the plant, reviewed its mode of operation, and discussed the status of its affairs and the progress of its work with its management and supervisory personnel."

The report disclosed a number of important points:

1. The plan of organization approved by the controlling company had not been put into effect, with the result that some activities were organized in a manner never approved by proper authority.
2. Liaison between conversion plant and head office had been unsatisfactory.
3. No person had been designated for the maintenance and further development of the plant's standard practice manual.
4. Responsibility for certain stores was to have been transferred. This had not been done.
5. Surplus stocks of contract material appeared to be excessive.
6. Control of material quantities sent to subcontractors appeared to be inadequate.
7. Certain accountability records of importance had not been completed on schedule.
8. Periodic physical inventories had not been complete.
9. Physical inventories had not been taken by disinterested persons.
10. Internal check in the payroll department was inadequate.
11. Stockrooms did not maintain adequate records to show the definite location of all parts and materials stored.

Enumeration of these findings should illustrate the value to management of this

type of assignment. A few trained men, in a few weeks, had been able to give to the home office a very detailed picture of operations at this plant. It is almost as if the executive office could see into the operations with a long-range telescope. The situation as it exists is set forth clearly for managerial review and action. In the forty-eight pages of the report all necessary information is given to support the summarized findings.

The report is divided into sections, each section giving the findings for a particular area of responsibility at the head office. For example, one part is directed to Organization Control Department, another to the Chief Accountant, and another to the Material and Procurement Department.

The Chief Auditor was responsible for seeing that the report went to every administration and supervisory person concerned, in order that the full value of the report would be realized.

Returning to our own industry, the next case history deals with a check of truck deliveries. At this point it might be well to explain the origin of special assignments. In our company, the head of the internal audit department reports through the Assistant Treasurer to the (financial) Vice-President. Above the latter is the President, with whom there is not much direct contact. Special assignments are handed to the internal audit department by all three executives, or may be initiated by the head of the audit department. In actual practice, most of them originate with the Vice-President and Assistant Treasurer.

To proceed with this example, good delivery service is essential in the meat industry. Every shipment from a plant or warehouse contains food that is highly perishable. If it is not properly packaged and handled, if it is not delivered promptly under correct temperature conditions, important losses may result to the company and to the community's food supply. Moreover, the fierce competition in the meat industry makes it necessary that our delivery service be of the best. A still further reason for the checking of our deliveries is the possibility of theft, effected by collusion between plant workers and truck drivers.

The daily responsibility of the foregoing rests, of course, with the superintendents and foremen in charge of shipping and deliveries. They should maintain high standards and keep alert for misdemeanors. It is human nature, however, to live with an operation and not detect the signs of deterioration. Inefficiencies creep in unnoticed by those charged with day-to-day supervision. The following episode will illustrate this.

On this assignment it was decided to check the deliveries made from eight trucks going to various points within a radius of 100 miles. These trucks are loaded in the night and begin delivery at their earliest point of call as soon as business opens for the day.

Four internal auditors and four senior men from the general office were selected. Without any previous warning they were given sealed instructions at 5:00 o'clock in the afternoon, which ordered them to report to the audit department office at 3:00 o'clock in the morning. This secrecy is necessary to prevent any hint of the check leaking out to the shipping and trucking departments. Any such warning would destroy the usefulness of a check of this kind.

This assignment illustrates one method of enlarging the scope of a small internal audit department. That is, four men from the general office were used in the assignment, since it was of such a nature that specialized training was not necessary, and very explicit written instructions were given. The same principle can be applied

to other special assignments. It is necessary, of course, to carry the support of local management in such cases, as we would not think of summarily drafting men without a previous understanding with their superiors.

The eight trucks were boarded by the auditors just as they pulled away from the plant. The auditors presented a letter of authorization to the drivers and requested possession of all delivery documents. At each call, the auditor checked the goods against the shipping bills, examined the condition of the goods, and generally observed the whole delivery process. Without stressing that there was anything special about the visit, customers were invited in friendly fashion to give their opinion of our goods and service.

A written report was made by each man upon return to the office, and these reports were summarized by the audit department. Reports and summary were sent to management and all operating departments concerned. The summary of this particular check was briefly as follows:

1. Two items on the trucks were not covered by invoices, and one item was invoiced but missing from the truck. These were fully investigated by the internal audit department, which found no evidence of dishonesty but did find errors and weaknesses in loading and checking.
2. Some trucks were loaded, pulled up on the road outside the plant, and left for as long as an hour without guard.
3. Trucks were left at sub-depots, awaiting drivers, without guard.
4. There were some delays between completion of loading and departure of truck. This resulted in late deliveries and product deterioration.
5. Due to improper packaging, there was damage to other goods from certain meat products which must be shipped in a wet condition.
6. Heavy goods were being loaded on top of lighter packages.
7. Cartons were improperly stitched, due to failure to follow instructions.
8. The white coats worn by some drivers were not clean enough, and some needed repair.
9. One truck was badly overloaded.
10. The time schedule for loading and dispatching needed revision.

As previously stated, the report of these conditions was sent to all management personnel concerned, with the result that steps were taken to correct the weaknesses revealed. While these conditions may have come to light one by one, an investigation of this kind was able to focus attention quickly on all shortcomings of the whole operation.

FRAUD AND THEFT

The final section of this paper deals with a part of the internal auditor's work that is always unpleasant but nonetheless very important, the investigation of fraud and theft. There is a strong tendency among internal auditors today to play down their work in this regard, and to concentrate their efforts and ideas on other services to management. Such a trend is all to the good, and the Institute of Internal Auditors is doing much to encourage it. Nevertheless, an internal auditor will be faced with work on defalcations, and for that work he should be well trained indeed, because it is very difficult and very specialized. The following examples will indicate some of the special techniques that are necessary.

It might be appropriate to remark at this point that inexperience in such investigations, and consequent lack of prompt action, has often resulted in failure of find out all the facts, inability to recovery all or part of the loss, and considerable waste of time. Nothing can play havoc with an audit program so much as a defalcation that takes weeks of investigation, and therefore the internal auditor should know exactly what to do, and how to do it quickly.

One of the common misdemeanors is the withholding of collections by salesmen.

They are usually detected by sending verification statements to customers, or by intelligently examining accounts. The following will illustrate both.

During the audit of one of our plants, our man sent out verifications to the customers on several sales territories, as soon as he arrived in that particular city. Several days later one of the verifications was returned with a notation that a small item was not in order. The territory concerned covered a number of small towns the center of which was about fifty miles from the plant.

The auditor decided to investigate at once, and on the spot, even though there might only be a mistake involved. Taking the local office manager with him, he drove to see this particular customer and found his suspicions confirmed. The customer's receipts showed that payments had been made to the salesman and had not been reported by him.

With one concrete example in his possession, the auditor had to decide whether to check further customers, or whether to question the salesman first. He decided on the latter, hoping that the salesman might tell him all the facts and save some time, even though the salesman's story would have to be verified later.

As is all too usual, and all too foolish, the salesman denied that there were any further items. He made the excuse that he had temporarily borrowed the amount already detected and intended to turn it in the next day. In denying further misappropriations, it is possible he thought he could cover up before the auditor completed his check.

The auditor immediately began calling on customers close at hand. The very first call disclosed a second shortage. For the next two days our man called personally on all accounts which might bear checking in this way, and completed the check by telephone and mail. Several more shortages turned up. Fortunately the whole amount was not large, but could easily have been greater if the salesman had not been caught early in the game.

On another occasion, the examination of an accounts receivable ledger disclosed one territory on which the number of overdue accounts seemed high. The auditor's suspicions were aroused, and he talked them over with the credit manager and the sales manager. The former agreed with the auditor, but the sales manager discounted the idea because of the long service and good record of the salesman concerned. He said the man was just doing a poor collecting job.

The auditor was not satisfied and went to his superior. The chief auditor decided that the suspicion was strong enough to warrant investigation. He despatched an auditor by train that night to the city concerned, about 200 miles away. The next morning he had a telephone call from the auditor saying that the salesman had been contacted on arrival and had at once confessed to a shortage of approximately a thousand dollars. He gave the auditor a list of accounts and amounts involved. The auditor then drove with the salesman to see every customer. In this case, an unusual one, it was verified that the salesman had given the full facts when first challenged.

The important conclusions to be drawn from these cases are, first, that it pays to investigate promptly even slight evidence or suspicion of defalcation. Second, the investigation must be carried out quickly and completely, before there is a chance to cover up. In many cases of this kind, the auditor will be working alone and, therefore, must make the decision as to course of action.

In this type of assignment, the internal auditor must be able to make friends with the company's customers so that he will be given free access to all records neces-

sary. He should not, however, discuss the matter, but leave the impression that the check is routine. A knowledge of retail accounting is helpful, so that the auditor can get quickly to the essential documents and information he needs.

In another case several years ago, two of our internal audit staff were covering a routine audit at a small plant. On such an audit all departments are examined fairly closely, as the local staff is small and it is difficult to build much internal check by sub-division of duties. In other words, various individuals have considerable local responsibility. An example that fits into this case is that the manager of the dairy products department, or produce manager, not only did the buying and selling of his particular lines but had some accounting duties in connection with inventories and weekly profit and loss statements. This particular man was a trusted senior employee of many years' service.

In the examination of this department, part of the inventory was taken and found correct. More inventory was to be checked a few days later. In the interval, inventory prices of butter were compared from week to week, and were found to have been increased a quarter of a cent a pound for no apparent reason except to the suspicious mind of the auditor, to make the operating results look a little better in some weeks. There were also some mistakes in the storage records.

The produce manager's explanations of this were vague, and the auditor deliberately gave out a broad hint that he was going to check some more inventory the next morning.

Late that night the local plant manager reported to the auditor that the produce manager had confessed to a shortage of $1,800.00 in inventory. He claimed he had raised inventory prices and quantities to cover trading losses, hoping to redeem them later.

Next morning, the auditors took the following steps:

1. The inventory was completely checked. It consisted of merchandise and supplies stored at the plant and several outside storages. The shortage proved to be in the neighborhood of $10,000.
2. Examination of vouchers and accounts revealed forged receiving and purchase vouchers, storage vouchers abstracted from the mail and destroyed, and fictitious purchases and sales with outsiders. Shortages were covered up by forged verification statements, and by assistance from a storage clerk.

It was quickly apparent that it was most important to find out the receivers of the stolen goods. The fictitious sales supplied the names of two wholesalers, and these were visited at once by both auditors, before the man involved could say much to them, and before they could think up good stories. Both auditors went, as two witnesses are better than one.

The wholesalers were caught off balance. At one place the auditors demanded to see the books. The man concerned was frightened and had not had time to see his lawyer. Without realizing he could refuse, he brought out his books and the auditors found valuable evidence therein. The other man was visited in the same hour. He, too, was bluffed into showing records and gave considerable verbal information which was promptly written down by the auditors.

As was to be expected, both men immediately sought lawyers, but the damage had been done so far as they were concerned. The auditors had made the right decision in hastening to see them within hours of finding traces of collusion with outsiders.

The next steps were long and painstaking, that of examining records and of questioning suspects and others. This tedious work is often avoided by investigators, but we consider it very necessary. By this means we try to build up a factual

story of the misappropriation, and we try to obtain the maximum of documentary evidence. This latter is very useful in court, if necessary, and often leads to admissions by the person concerned when confronted with it. Further, the internal auditor must always think of trying to recover the amount stolen.

Defalcations of the kind illustrated are seldom easy to trace, and this was no exception. When we were finished we were not sure that we had uncovered the full extent of the thefts, and we were able to trace only a portion of the stolen goods. For the most part, we could tell when the shortages occurred and the method of covering them up, but we were unable to find where most of the goods went.

Because of lack of complete evidence from the files and from the men involved, our auditors undertook a very thorough cross-examination of every person, in our employ or otherwise, who had associated with the malefactor. This took several weeks, because the same ground was covered several times with the same people. This persistence was finally rewarded when a women remembered visiting a certain bank with the wife of the suspected man. That minor item enabled our men to locate several bank accounts, recover some of the money and obtain additional evidence.

The methods used to escape detection in this case were interesting. Some of them were simple, but were possible because of the carelessness of other employees.

1. Vouchers from storage companies were abstracted from the mail and, therefore, not posted.
2. Inventories and storage records in this small plant were in the control of the guilty man. He falsified them as he saw fit.
3. Independent checks of the inventories were circumvented by false verification statements, withholding of purchase and receiving vouchers, fictitious sales, and sheer carelessness of some checkers.
4. There was collusion with outside persons in the case of false verification statements and fictitious purchases and sales.
5. The bank records revealed the payment of bribes by certain wholesalers to invoice one grade of goods, but deliver an inferior grade.

It will be obvious that we took immediate steps to plug all the loopholes thus revealed, and the systems at all other plants were examined for similar weaknesses. The audit had the further result that a portion of the loss was recovered, but not all of it. The evidence collected was sufficient to bring all concerned into court.

CONCLUSION

The following qualifications appear to be those most needed by an internal auditor:

First, he must be an experienced accountant. Many graduates of good accounting and business courses in schools and universities want to step at once into the internal audit department. Possibly the glamour appeals to them. The recent graduate will do better in the long run by first obtaining considerable experience in clerical, accounting, and operating positions. This seems especially true when thinking of a job like internal auditing, which deals mostly with the things that go wrong, not with those that go right.

Second, only a man who can think quickly on the spot and is willing to make decisions on his own will ever be a good internal auditor.

Persistence and patience are other necessary qualifications, as illustrated in several of the cases above.

Finally, the utmost ability to be tactful, diplomatic and personable is needed. An auditor spends much of his time interviewing and questioning all kinds of people. He must get results without antagonizing, and without saying one word that might be harmful to himself, his department, or his company.

A "SOURCE AND APPLICATION OF FUNDS" PHILOSOPHY OF FINANCIAL ACCOUNTING

A. B. Carson

The "source and application of funds statement" embodies a viewpoint that provides the seeds of a philosophy of financial accounting. This viewpoint encompasses many matters. It suggests an order of the importance of the various things that accounting attempts to accomplish. It casts a light in which some practices and "principles" appear to have small import while others show up with heightened significance. It draws attention to the importance of working capital elements to business organizations. It endorses a concept of business management which, in turn, suggests what may be considered as the central purpose of accounts kept by management.

This "source and application of funds" viewpoint serves as a reminder of the differences as well as the similarities of various types of expenses and income. It provides an answer to the qsestion of "cost vs. value" in the asset accounts. It suggests a slight revision of the form and content of the conventional balance sheet. Finally, it offers renewed meaning to the terms *debit* and *credit*.

Since it is the purpose, form, and nature of the source and application of funds statement that suggests these things, a brief review of the origin, current form, and mechanics of preparation of this report is included as a preface to the consideration of the matters mentioned.

THE SOURCE AND APPLICATION OF FUNDS STATEMENT

This statement is the outgrowth of what was termed a "where-got, where-gone" analysis suggested by William Morse Cole and presented in a book he wrote forty years ago.[1] His idea was that the movement of resources could be traced by noting the changes in the individual asset and liability items between two points of time. Increases in assets and decreases in equities showed the disposition of resources ("where gone," expenditures, or debits), while the reverse indicated the source of resources ("where got," receipts, or credits). He later changed the terminology to "sources of values" and "applications of values."[2]

In 1921, H. A. Finney used the terms *funds provided* and *funds applied*.[3] The term *funds* was used in the broad sense of "resources" or "values." Over the years, however, the emphasis has shifted until, at the present time, most (though not all) writers and practitioners consider funds to be net working capital or net current assets.[4]

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[1] *Accounts; Their Construction and Interpretation* (Boston: Houghton Mifflin Company, 1908), pp. 97–102.

[2] *The Fundamentals of Accounting* (Boston: Houghton Mifflin Company, 1921), pp. 348—50.

[3] "Students Department," *Journal of Accountancy*, July, 1921, pp. 65–67.

[4] An informal sample of a dozen recent and widely used texts on accounting and statement analysis disclosed that all defined or treated "funds" as net working capital (current assets minus current liabilities). A few indicated that funds, in the most strict sense, should be limited to cash, although they did not employ this treatment. Hiram T. Scovill, in an article entitled "Application of Funds Made Practical," The Accounting Review, January, 1944, makes a strong case for considering funds as "practically synonymous" with cash. Maurize Moonitz, in an article entitled "Inventories and the Statement of Funds," The Accounting Review, July, 1943, shows the advantages of considering funds as cash, short term receivables, and highly marketable securities held as secondary cash reserve, less short term payables. He suggests occasions when a more limited concept might be necessary. The writer agrees with Dr. Moonitz on the matter of excluding inventories, but follows conventional practice in the present discussion.

The source and application of funds statement is now considered to be a unique and useful financial report. Among other things it supplies an answer to the question: "What happened to the profit?" "How was the loss absorbed?" It gives an overall picture of financial changes occurring between two points of time (usually balance sheet dates), putting the emphasis on the sources and dispositions of net working capital. It shows whether a business is expanding or contracting. It reminds the reader that funds from various sources become merged in the business process.

The conventional form of the statement has two sections: funds provided (or secured) and funds applied. If net working capital has decreased, the amount of the decrease is included as a source. If it has increased, this shows as an application. Sometimes the working capital change is set forth as the residual or difference between other sources and applications.[5] Often a detailed schedule of working capital is included, showing the changes in the individual components.

Customarily, the net profit as reported in the income statement is the first item shown among the sources. To this are added back various non-working capital charges to income, such as depreciation and bond discount amortization. Any non-working capital credits to income are deducted. Any profits or losses from the sale of non-current assets are subtracted or added so that the total funds from transactions of this sort will appear in one place on the statement. The resulting amount is usually called "funds provided by (current) operations." Besides funds from operations, other sources of funds during the period may include the proceeds from the issuance of stock or bonds or the sale of non-current assets. Funds applied may include dividends declared or declared and paid, non-current assets purchased, and redemption of long term debt or stock. As mentioned above, the change in net working capital is properly inserted to balance other sources and applications, or is shown as a residual.

The mechanics of preparation of the statement commonly involves a worksheet whereon comparative balance sheets are arranged in adjacent columns followed by a pair of columns into which amounts representing the change, or net debit or credit excess, for each item may be entered. Usually a separate pair of working capital columns is employed. Into these are extended the debit and credit "excesses" for the current assets and liabilities. Thus, the balancing amount will represent the change in net working capital. In most cases it is desirable to have a pair of adjustment columns which may be used to reverse out any appreciation entries, unscramble the surplus change into its components, and reclassify various items for more effective presentation in the statement. Finally, the various items as adjusted and reclassified are extended into the last pair of columns, the debit one for funds applied, and the credit one for funds secured.

At the present time the source and application of funds statement cannot be considered a "primary" financial report. It is considerably overshadowed by the balance sheet and income statement. There is some evidence, however, that it is gaining in significance. It is showing up in more

[5] Harry L. Knuze, in an article entitled "A New Form of Funds Statement," THE ACCOUNTING REVIEW, June, 1940, suggests an interesting statement arrangement. It starts with the amount of net current assets at the beginning of the period. Following this the source items are shown. The application items are then deducted. The difference between these two is added or subtracted to arrive at the net current assets at the end of the period. Another feature is the showing of sales and other income among the sources, with expenses that decreased working capital shown among the applications. This latter treatment (which has been recommended by several writers) avoids the necessity of "adding back" the non-working capital charges.

and more published reports. There is a noticeable increase in the attention being given it by writers on accounting.[6] The fund change technique is gaining in importance as a tool of financial analysis. There is some reason to hope that the statement may some day rank with the balance sheet and income statement as a basic accounting report.

IMPORTANCE OF NET WORKING CAPITAL

It is unnecessary to dwell at great length upon the importance of net working capital. It is generally agreed to be the circulatory system of a business organization. Its maintenance is a matter of prime concern to management. Without it payrolls cannot be met, credit sources dry up, volume cannot be maintained, and discounts are lost. To keep it active and working, potential profits are often sacrificed. Lack of it is a major reason why going concerns slow up or stop.

Financial accounting, reporting, and analysis have traditionally given working capital considerable attention. Current assets and liabilities are usually displayed in prominent positions on the balance sheet. Various rules, standards, ratios, and turnovers have been devised to measure and judge current position. The source and application of funds statement provides further information. It supplies an answer to the most fundamental question: Where or how was net working capital secured and how was it used?

If working capital matters are this important, perhaps they deserve an even more significant place in a philosophy of financial accounting. Perhaps the major purpose of the accounting process is (or should be) to keep records of working capital, and its sources and dispositions.

[6] For a discussion of the status of the source and application of funds statement see: George D. McCarthy, "Funds Statements Can Make Financial Statements Easier to Understand," *Journal of Accountancy*, April, 1948.

MANAGEMENT AS A FIDUCIARY

Many writers on accounting matters have observed that the position of management in modern business corporations is closely akin to that of a trustee. While this may not be true in a strict legal sense, it is fair to say that management is in a fiduciary capacity ethically and actually. They stand in this relationship with the stockholders primarily, and to a lesser extent with creditors, employees, governmental agencies, potential investors, and the public at large.

If this is the position that management occupies, it is clear that financial accounting must provide, above all else, records that show the source of all funds provided to or secured by the management, and the disposition they have made of them. Very likely most accountants would agree that such records would constitute the minimum requisite of good accounts of a business undertaking. The point, however, is the matter of relative emphasis. Keeping a record of the sources and dispositions of funds is not merely a starting point: it may well be the foundation and framework of the whole accounting structure. In their necessary efforts to satisfy other needs, accountants should not lose sight of this fundamental function.[7]

MATCHING OF INCOME AND EXPENSE

In the source and application of funds view of the accounting process, the problem of periodic income determination, involving the matching of cost and revenue, becomes secondary. That detracts little from its importance, but suggests that attempts be made to handle it in the accounts and statements in a way that will not obscure the source-application aspect.[8]

[7] George O. May lists ten major uses of financial accounts in his book, *Financial Accounting* (New York: The Macmillan Company, 1943), p. 3. The first item on the list is "As a report of stewardship."

[8] To some extent the source-application aspect is made subsidiary to the matching process by the very

This difficulty of the fund flow feature becoming clouded by the process of matching income and expense occurs whenever an item that was not an application of funds during the period must be treated as an expense of the period. The same is true of anything that must be considered as income or expense reduction that was not a source of net working capital during the same period. This is merely another way of recalling the fact that "expenses" and "disbursements" are not synonymous, nor are "income" and "receipts," even when disbursements and receipts are understood to refer to working capital rather than merely cash.

There are several cases of this sort. Probably the most important one is depreciation. Accountants have taken great pains to convince everyone that depreciation is just as much an expense of a period as, for example, sales salaries. Their efforts have had considerable success. It is suggested, however, that they may have oversold the idea a bit. There is much to commend the process of attempting to charge the cost of an asset to the periods it benefits. Such treatment is the very core of conventional accrual accounting. That, however, is no reason to suggest or imply that depreciation and similar write-offs are exactly the same as most other expenses. Business people know that such is not the case.

In order that the matching process will not entirely obscure the source-application of funds aspect, perhaps little more can be done than to always present fund change statements along with income statements. Thus, when depreciation and other non-fund expense and income items are added back or deducted from the amount shown as net profit in the income statement, their special nature becomes apparent. Further clarity might be accomplished by the careful labeling of such non-fund charges and credits in the income statement, and by keeping such items separate in both the accounts and the statement. For example: do not report one amount for bond interest expense, but show both the amount paid (or accrued) and the amount of premium or discount written off. In non-manufacturing concerns (where depreciation and similar charges do not become a part of the cost of inventories) all such non-fund items might be grouped together under an appropriate label.[9]

Finally, in the interests of keeping both the source-application of funds and the periodic income aspects from becoming mutually confusing, it might be wise to give complete information in all affected statements about transactions involving the sale of non-current assets. For example: assume that a piece of equipment with a book value of \$5,000 was sold for \$6,000 and the profit carried to the income account. In the income statement let both book value and sales price be shown. In the fund change statement this gain will be subtracted from the amount of net profit as shown in the income statement so that the entire \$6,000 may be shown as funds secured from the sale of equipment. If a cost is shown parenthetically at this point, the reader should be able to fully understand what happened.

ASSET VALUATION IN THE ACCOUNTING PROCESS

The question of whether the asset accounts should reflect costs or current values or replacement costs is receiving renewed consideration because of the post-

fact of defining "funds" as working capital rather than as cash. In this way sales, whether collected or not, can be considered as a source of funds, and most costs and expenses, whether paid or not, as a disposition. With the possible exception of the inclusion of inventories in working capital, there is little objection to considering working capital as funds. The "nearness" to cash of receivables, temporary investments, and payables gives excellent reason for such treatment.

[9] Mr. Roland W. Funk, a colleague of the writer, suggests that such income statements might be so arranged that an intermediate figure, possibly called "Funds provided by operations," could be shown. This amount then could be the starting point in the source and application of funds statement.

war price rise. In the past those who favored the showing of current values argued that this should be done so that the balance sheet could be a real "statement of condition."[10] A more persuasive reason is currently advanced. It is claimed that the prevailing method of calculating periodic income is unsuited to anything but a stable price level. The adoption of a concept of "economic" income is proposed. In this view, no net income is deemed to emerge unless and until there is provision for the maintenance of "real" or "economic" capital, in contrast to mere "dollar" capital. The substance of the proposal is that depreciation and cost of sales should be calculated on a replacement cost basis. Presumably this would require formal recognition of estimated replacement costs in the asset accounts. The adoption of such a concept at the present time would entail, in most cases, the recognition of appreciated asset values.

Strong traditions oppose such procedures. Recording appreciation violates the principle of conservatism (in the balance sheet, at least) as well as the doctrine of realization. Accountants have been loath to inject any more subjectivity into their record keeping than was absolutely required by the necessity of trying to match cost and revenue. There is a widespread feeling that financial records would become a mere collection of various opinions if the door were fully opened to subjective considerations. Probably most accountants feel that supplementary notes, schedules, and statements can be used to present such additional information.

The answer to the question of whether the asset accounts should show cost or value is fairly obvious when the source and application of funds viewpoint is adopted. It requires cost. This can be the only answer when accounting is regarded as essentially a process of keeping historical records of the sources and dispositions of net working capital. This view places the emphasis on "how much" was applied or used to secure resources and services. Subsequent increases in value are not matters to be recorded since they do not represent the application or disposition of any additional working capital.

This does not necessarily mean that the source and application of funds view of the accounting process is entirely incompatible with a concept of "economic income." The latter has much in its favor, although its adoption appears unlikely. The point of present significance is that the calculation of net income, by any means, is secondary to the function of recording the sources and dispositions of funds. There is very little room for "values" in this process.

A. SOURCE AND APPLICATION OF FUNDS INTERPRETATION OF THE BALANCE SHEET

The balance sheet is usually regarded as a statement of the assets and equities of a business organization at a specified date. If it does not show appraised values and does not reflect the results of recapitalizations, and "quasi-reorganizations," it may also be viewed as a statement that shows the working capital of the company, the unamortized portion of various past applications of funds, and the sources of these elements. When the source and application of funds philosophy of accounting is adopted, the balance sheet takes on the latter nature. If this view is accepted, a few modifications of conventional practice suggest themselves. While they are not essential to the acceptance of the proposed view of the accounting process, their adoption would make for consistency of form, principle, and improved emphasis. For reasons other than those advanced here, many of these changes are already making an appearance in published reports.

[10] For elucidation of this viewpoint see: Kenneth MacNeal, *Truth in Accounting* (Philadelphia: University of Pennsylvania Press, 1939), and William H. Whitney, "What Is A Balance Sheet?" *Journal of Accountancy*, October, 1940.

The first departure from conventional practice that is suggested is the manner of showing current assets and liabilities. If the latter were deducted from the former, the difference—net working capital or net current assets—would receive greater emphasis. This seems desirable in itself, and would be doubly so when comparative balance sheets were presented. The change in this item would then conveniently "tie in" with an accompanying source and application of funds statement.

With two notable exceptions, the remainder of the items on the left or "debit" side (or portion) of the balance sheet could be shown and grouped in the conventional manner. The first of these exceptions relates to the presentation of fixed assets. In spite of the fact that there seem to be few, if any, who commend the use of the expression "Reserve for Depreciation," it is hard to kill. It is certainly a misleading term. It seems especially inappropriate to the interpretation of the balance sheet herein proposed. Two alternatives suggest themselves: either continue to show cost and deduct therefrom "cost allocated to operations to date" (or other similar expression), or simply show the net amount with some such label as "cost not allocated to operations."[11]

The other suggested departure from the conventional showing of debit items on the balance sheet relates to discount on bonds payable. If there is such an item it is usually shown as a deferred charge. This is sometimes defended on the grounds that it represents, in reality, prepaid interest. Many question such a reason, but include it anyhow for want of a better place to put it. Some would deduct it from bonds payable in the fixed liability section on the theory that the net amount thus shown represents the present value of future principal and interest obligations.

In the source and application of funds view of accounting, bond discount has no reality as an asset since it does not represent any application of funds (nor the equivalent), past or current. This leads to the conclusion that bond discount is not an accountable item and, accordingly, has no place on the balance sheet. Since it is so intimately connected with bonds payable, it will be further discussed in that connection in later paragraphs.

If the balance sheet is modified to emphasize the source and application of funds aspects, the liability and capital sections deserve some rephrasing and reforming. At the outset, the general heading "Liabilities" or "Liabilities and Capital" might be abandoned in favor of "Sources of Funds" or other similar expression. It has already been suggested that current liabilities be deducted from current assets. While such handling is not absolutely essential to the balance sheet form that is being proposed, it is consistent with the idea that current liabilities are negative fund elements.

"Funds Provided by Bondholders" (or Mortgage Holders) might be substituted in place of the heading "Fixed Liabilities." In this section there could be a brief summary of the salient features of the bond issue. This might include such matters as the dates of issue and maturity, the interest rate, and the type of security. The major departure from current practice, however, is the suggestion that the amount originally secured from the sale of the bonds be shown. If this was less than the face value, let the periodic amount that is charged to operations to amortize the "discount" be accumulated as an addition to the amount originally secured from the sale of the bonds. This amount, increasing

[11] This expression was used by the Caterpillar Tractor Company in the "Financial Position" statement of their 1946 Annual Report. Attention is called to this report, and the article about it by W. Blackie, "Financial Statements for Corporate Annual Reports," *Journal of Accountancy*, March, 1947. The form and content of their exhibits is consistent in many important respects with the suggestions embodied in this discussion. Among other things, they show current assets and liabilities in the manner suggested above.

year by year, could be labeled "Add: Amounts Charged to Past Operations to Offset Sale of Bonds at a Discount." If the bonds were sold at a premium, an ever increasing amount, properly labeled, would be deducted. In this way the actual funds provided by the bond issue is always shown and the true nature of the charge or credit in the income statement is more clearly explained. The face amount of the obligations outstanding might be shown parenthetically.

The capital section of the balance sheet might have two sections: "Funds Provided by Stockholders" and "Funds Provided by Retained Earnings." In the first of these sections the number of shares of each type of stock issued, along with mention of any special features such as voting rights, dividend rights, redemption rights, and par or stated value could be indicated. For each type, however, let the *total* amount originally received be shown. If any of the shares had been repurchased, their number and *cost* could be deducted. Here again, the emphasis is placed upon the amount of funds secured from this source (less any returned to it). Legal niceties involving such items as premium and discount, surplus from treasury stock transactions, and surplus from recapitalization are thus avoided. Fortunately, the showing of these things seems to be on the decline. An increasing number of balance sheets are being prepared with a simple, straightforward showing of capital provided by shareholders. This seems a wholesome development in financial reporting under any philosophy of accounts.

The section, "Funds Provided by Retained (or Undistributed) Earnings," need contain nothing more than that amount opposite the suggested designation. It is felt, however, that the philosophy espoused would be better served if the total earnings from the inception of the concern to the date of the balance sheet were shown, and from this the total dividends declared to date, deducted. In this way both a major source and an important application of funds would be shown. It would provide a comprehensive view of the fortunes of the undertaking from its inception (which date should, of course, be indicated).

In the last section neither the words "surplus" nor "reserve" would appear. That feature alone should warrant the adoption of the form proposed. As will be suggested in the next section, it is debatable whether the "appropriation" of surplus is an accountable event. If the directors of a corporation feel compelled to advise stockholders and others that they cannot or do not intend to distribute all past earnings as dividends, they may say so in a footnote. The source and application of funds record need not be cluttered up with such matters.

A few words may be added regarding the title of the statement. A number of companies are dropping the expression "Balance Sheet" in favor of such headings as "Financial Position," "Financial Condition," or "Statement of Condition." It is debatable whether statements prepared according to conventional principles actually deserve to be called any of these things. A statement prepared in the form just proposed does not embrace a value concept and could not be termed a "Statement of Condition." For that reason, no change in title is suggested. The term "Balance Sheet" is acceptable. It has been generally devoid, in the past, of any implication of current values. It is compatible with the form proposed since it draws attention to the balance or equality of funds secured and applied.

It should be reiterated that the changes suggested are consistent with, but not essential to, the source and application of funds philosophy. Balance sheets of the conventional (or other) type may be scrutinized from this viewpoint. Their susceptibility to this type of interpretation affords one measure of their quality.

A SOURCE AND APPLICATION OF FUNDS THEORY OF DOUBLE ENTRY

The source and application of funds view of financial accounting can be extended to embrace the bookkeeping process of debit and credit. A theory of double entry bookkeeping can be developed that is consistent with the general philosophy of accounting and reporting that has been suggested. The extension of this viewpoint to the mechanics of bookkeeping is optional. Since double entry is so widely used, however, a discussion of debits and credits as expressions of applications and sources of funds is included.

Cole, in his early text, explained bookkeeping entries in somewhat this way, although he did not include the working capital fund concept. In summarizing a chapter on *Debit and Credit* he states: "Double entry, then, means not that each transaction is entered twice, but only that each transaction is entered from a double point of view—cause and effect, or source and destination."[12] This approach to the subject did not become popular. Instead it has become common practice to explain debits and credits as basically a mechanism for recording increases and decreases in asset, liability, and capital elements—the "real" accounts. Income and expense are termed "nominal" elements and treated as partial explanations of net worth changes. Possible the essential significance of the accounting process might be clarified by a shift to a source-application of funds concept of double entry.

The source and application of funds theory of debit and credit may be developed along the following lines: As a starting point assume that the only purpose of financial accounting is to keep a record of working capital. Accordingly only transactions and events involving current assets and/or current liabilities will be recorded. As has been indicated, there is some reason to question the logical validity of the inclusion of inventories as current assets. Since their status is so firmly sanctioned by custom, however, no change is here suggested. The working capital fund will be considered to include cash, notes and accounts receivable (including accrued receivables), temporary investments, and inventories as current assets; and notes and accounts payable (including accrued payables), and advances by customers as current liabilities.[13] Since practice is not uniform with respect to prepaid expenses, they are excluded.

Every transaction or event involving the working capital fund or any of its elements is considered to have two phases: a source aspect and an application aspect. For example: if net working capital is increased as the result of some explicit transaction or due to the accrual of a current asset, the *reason* for such increase is the source, and the increase of the net working capital fund itself is the application. Common reasons (sources) include the sale of assets, stock, or bonds, as well as income from services rendered. A decrease in the working capital fund itself is also a source. The funds so secured might be used to acquire some non-current asset or some service, or to retire long term debt, or make payment to shareholders. The decrease might be due to a loss in the value of a current asset item, or to the accrual of a current liability. The reason, whatever it is, is the application aspect.

The recognition of sources and applications or dispositions of working capital seems easily understandable. It is not so obvious that an increase in net working capital is an application of funds, while a decrease is a source. However, if the work-

[12] *Accounts; Their Construction and Interpretation* (Boston: Houghton Mifflin Company, 1908), p. 14.

[13] Accruals, both receivable and payable, are considered at this point because they are legitimate working capital components; not because of their significance in the income determination process.

ing capital fund is thought of as a "reservoir" in the flow of funds process, the concept gains clarity. Adding to the fund is an application. The withdrawal of some is a source.

There are, of course, many transactions wholly within the working capital fund such as collection of receivables, payment of payables, short term borrowing, and merchandise purchases on account.[14] One component changes in a way that would increase the fund, while another changes in a way that would diminish it. The former is the application aspect; the latter, the source aspect.

Before attempting the formulation of any general rules of debit and credit, it is necessary to broaden the scope of the transactions to be recorded. The discussion to this point has clung to the proposition that only transactions involving working capital are to be considered. If such a limitation were imposed in practice no record would be made of assets that were acquired or expenses that were incurred in transactions that did not involve any working capital component. An example is the fairly frequent situation wherein a corporation acquires non-current assets in exchange for its own stock or long term obligations. Another case is the exchange of non-current assets for other non-current assets or for services. Certainly such events deserve accounting recognition.

In order that these transactions may be included within the framework of the theory being developed, it is necessary to resort to a pretense. It must be pretended that the assets parted with, or stock, mortgage, or bonds issued were sold for a "cash equivalent" and that this was used at the same moment to acquire the non-current assets or services received. Thus, a single transaction is regarded as two events with offsetting effects on the working capital fund.

This pretense has some justification. The transaction may be, in fact, very close to what was pretended. Of more importance however, is the thought that such a record can be valid only if the amounts recorded represent a price at which they reasonably might have "gone through" working capital. That, of course, is merely restating the rule that requires the valuation of items acquired in an exchange at their fair market value (the "cash equivalent" of a "bargained price").

To reflect the source and applications aspects of every transaction or event in the ledger accounts, sources will be credits and applications will be debits. Stated in more formal fashion: An entry called a "credit" will be made in the right or credit column of an account whose title indicates where or how the funds (or their equivalent) involved in the transaction or event were secured. An entry, of an equal amount, called a "debit" will be made in the left or debit column of an account whose title indicates the application or disposition of the funds (or their equivalent) involved in the transaction or event.

In the majority of cases, the practical application of these rules would result in entries identical to those made when the conventional rules of debit and credit are followed. In a few instances this would not be true. For example, if stock or bonds were sold at a premium or discount, only the amount received would be credited to the bonds payable or capital stock accounts. Such treatment makes for clarity and simplicity.

Since it is helpful in many cases to have a record of the gross source and application of funds, it is advisable to consider that certain transactions are really a pair of concurrent events (even if net working

[14] It is suggested by implication that the inventory accounts are kept on a "perpetual" basis. The exposition is simplified by this treatment, though the concepts suggested are entirely compatible with the "periodic" treatment of inventories.

capital is involved). Practical necessities often require such treatment. A notable case of this sort is the sale of merchandise. Such a transaction is best understood as a debit to cash or accounts receivable (the application of funds received), and a credit to sales (the source) at the sales price, and a debit to cost of goods sold (the application) with a credit to merchandise inventory (the source) at cost price. Sales of assets other than merchandise might be handled in similar fashion.

When the end of a period is reached both current assets and current liabilities would be adjusted to reflect accrued items. While the process of making such adjustments is usually considered as being required primarily for the sake of making a correct calculation of net income, it is just as much a process of correctly stating current assets and liabilities as of a certain date. Since these accrued items are components of the working capital fund, they may be recorded according to the rules of debit and credit just suggested. It does not matter that such debits and credits are a type of "adjusting" in contrast to "transaction" entries; both are source and application of funds entries.

A trial balance taken after these entries have been made would show the correct amount of current assets and current liabilities, and a number of other accounts whose balances, if credits, would represent sources of working capital and, if debits, the applications. It is to be expected that all of the working capital accounts would contain both debits and credits. The current assets would have debit balances since they constitute applications, while the current liabilities would have credit balances inasmuch as they represent sources within the fund itself. Outside of the working capital group the accounts with debit balances would probably include such things as permanent investments, fixed assets, dividends declared, and certain types of expenses. The accounts with credit balances would include fixed liabilities, capital stock, and certain types of income. At this point there would be no expense or income accounts of the "write-off" or "amortized" charge or credit type. They do not come into use until a determination of periodic income is attempted.

The view of the double entry process that has been suggested has made but incidental distinction between assets, liabilities, capital, income, and expense. The fundamental distinction between elements of transactions (and working capital component accruals), as well as between the various accounts, has been the source and application aspect. It is only when a calculation of periodic income is undertaken that the distinction between assets and expenses and liabilities, capital, and income becomes significant.

In the source and application of funds view of the accounting bookkeeping process, the determination of net income (according to "accepted" standards) consists of deciding which and how much of the accounts with credit balances (sources) are to be considered income of the period, and which and how much of the debit balance accounts (applications) are to be considered as expenses. In general, such decisions are based upon conventional rules. The source elements where no further obligation of any sort exists, and which do not represent stockholders' contributions nor past undistributed earnings, may be considered as current income. Applications must be classified as between those that represent resources or values secured that will benefit the future, and those that may be considered to have expired. The "expired applications" that were not distributions to stockholders are expenses. Some of the applications are a mixture (depreciable fixed assets, for example). Sometimes some of the source

elements are mixed (for example: revenue received but only partially earned).

In the accounts proper, the profit determination process consists of removing—by offsetting debits or credits—all or portions of those source account balances that may properly be considered as current income, and all or portions of those application account balances that are current expenses.[15] To maintain the arithmetical equality of debits and credits the removed amounts of source and application elements will be credited and debited to a summarizing account—perhaps several in some orderly sequence, but with the net effect showing up in a "summary income" account. As a last step the application account showing dividends declared would be closed to this account, and the balance of it, in turn, carried to surplus or undistributed earnings.

In the process of offsetting or removing all portions of the affected accounts there is no objection to using "offset" or "valuation" accounts. Neither is there serious objection to first setting up in separate accounts the "expired" portion of certain applications, or the income element of certain sources, and then closing these out to the summarizing accounts. It is to be noted, however, that the debits and credits made in all of these adjusting and closing operations (not including the accrual of current assets and liabilities) are purely mechanical. Such entries are used merely to add and subtract. They, unlike the transaction and accrual entries, cannot be invested with any application or source significance. To try to attribute such qualities to them gives rise to needless confusion. If it is attempted it will result in such an anomaly as trying to consider a depreciation write-off credit to a fixed asset, or its valuation account, as a "source of funds."[16]

If the real significance of debits and credits (apart from those made to summarize and close certain accounts) is their application and source of funds meaning, certain things that are sometimes recorded in the formal accounts would seem to have no place. Recording asset appreciation is such a case. Another is the "setting up" of surplus reserves. Such debits and credits are not mechanical entries to summarize or close certain accounts, and to consider that they represent sources and applications of funds requires a very flexible imagination.

SUMMARY

Financial accounting can be regarded as essentially a process of keeping historical records of financial stewardship. Since working capital is such an important matter, the records should be maintained and various statements prepared in a manner that will not obscure the movement of working capital funds. The calculation of periodic income is a secondary function.

This viewpoint leads to what may be termed a source and application of funds concept or philosophy of financial accounting. It involves nothing essentially new except a shift of emphasis. Most of

[15] If bonds sold at a discount are recorded in the manner that has been suggested, special handling is required to include a write-off of the discount in the income calculation. A charge to income would be offset by a credit to some appropriately labeled account; perhaps "Discount Charged to Operations." As was suggested earlier, the balance of this latter account would be added to the bonds payable item on the balance sheet. The "Discount Charged to Operations" account is unique. It is neither a source nor a deduction from an application. It is merely a credit account that accumulates as a result of charges to operations that were never applications.

[16] One of the objections to the inclusion of inventories as a part of "funds" becomes apparent when the inventory includes items whose cost includes depreciation. If the increase in any current asset represents an application to the working capital fund, there must have been a source within or outside of the fund. The depreciation element was not secured within the fund. In a sense it represents the conversion of a fixed asset into a current asset. Thus, the credit to the fixed asset, or its offset account, was a source. Such reasoning, however, is unconvincing: depreciation is generally considered not to be a source of funds. The problem would not exist if inventories were excluded as a fund element.

the current principles and practices can be regarded in this light. An unqualified adoption of this viewpoint suggests some modifications of current practice. Both the income statement and the balance sheet may be restated to emphasize the fund change, or fund flow, aspect of business undertakings. The source and application of funds statement itself gains in significance.

The double entry bookkeeping process may be invested with a source-application meaning. Debits (apart from those made in the income summarizing process) can be interpreted as expressions of applications of funds, and credits (with the same qualification), as sources. It this is done, certain matters that are sometimes formally recorded would not be recognized in the accounts proper.

The source-application of funds viewpoint narrows the gulf between accounting for business organizations and for non-business undertakings, as well as for fiduciaries.

Without adopting or accepting all of the possible variations of existing practice that have been suggested, the source and application of funds philosophy may be used as merely one measure or standard by which accounting principles and practices, existing and proposed, may be evaluated.

A CONTROLLER'S CONCEPTION OF A MODERN ANNUAL REPORT

JOHN C. GRACE

A RECENT SURVEY by the Controllership Foundation to ascertain the *public's acceptance of the facts and figures of business accounting* disclosed three facts. First, the public has a grossly erroneous estimate of profits made by the manufacturers (forty per cent queried stated a rate of twenty-five per cent or more). Second, a large portion of the public does not understand much of the terminology used in financial statements of the past years. Third, a substantial percentage of the public distrusts the accuracy of the figures used in the reports, in spite of certifications by reputable public accountants and requirements of state and federal laws. Hence, top managements, the controllers, the public accountants, the educators, the American Institute of Accountants, and the Controller's Institute of America have a tremendous responsibility and an opportunity during the next five years to make the corporate annual report the keystone or media of communication to correct public and employee concepts of American business. Possibly, the progressive controller and top management of the manufacturing companies must take the initiative in this matter because the primary responsibility for the preparation of the financial statements depends upon the corporate management. This is permitted by the American Institute of Accountants.[1] The public accountant, however, should suggest and encourage the new trends toward modern, simplified or more readable financial statements as long as they are in accord with accepted accounting principles. Since the American Institute of Accountants, through its articles and research bulletins, largely establish the accepted accounting principles, it should accept this new challenge to promote, to suggest, to encourage these new uses of informative and simplified form and terminology. Yes, it should even *approve or suggest a model form*[2] of a balance sheet, statement of income and earned surplus (using the improved terminology, of course), and other parts of a complete annual report. This same challenge could also well be accepted by the Controller's Institute of America. In justice to both of these bodies, they are proving by their numerous articles in their respective magazines, the *Journal* and the *Controller*, that they are encouraging these new trends. The suggested model report would be a very progressive step by either body and I believe they should urge their members to participate more willingly in these trends

TRENDS IN GOOD ANNUAL REPORTS

Formerly, the stockholders and bankers were the principal recipients of the published annual corporate report. Now the audience is recognized as including the following additional groups: (1) the general public; (2) the customers who buy our products; (3) the employees whose cooperation we need for cost control and profit planning; (4) the labor unions whose cooperation is also needed for satisfactory profit figures; (5) the investment analysts whose favorable analysis is needed for successful financing; (6) government examiners who use the report to assist or to substantiate findings of their audits; and (7) creditors, both trade creditors and bondholders. Of course it is understood

[1] American Institute of Accountants, *Examination of Financial Statements*, 1936, pp. 4–5.

[2] The last one was in the 1936 Bulletin.

that top management has a separate and more complete financial report than the more or less condensed published report, although the principal statements, such as the balance sheet and the statement of net income, might well be the same.

The objective of an annual report was so ably stated by Alfred P. Sloan, Jr., Chairman of the Board, General Motors Corporation, in his introduction to his Annual Report at December 31, 1946, that it is repeated here:

> "The purpose of the annual report is to record for the information of the stockholders the more important transactions of the business and such economic events of the year as have been consequential in influencing its course. In the agregate, the annual reports serve as an historical record over the passing years. But indirectly, they also appraise the effectiveness of management in discharging its responsibility to the stockholders, and, more particularly as applied to the larger units of business, its responsibility to the economy as a whole. It is recognized, however, that such an appraisal cannot be made in the abstract solely on the basis of the related facts. Consideration must be given to the prevailing field of opportunity in which the particular business operates as well as to the economic circumstances governing enterprise in general."

However, financial reports, particularly technical terminology and figures, are difficult to understand. These reports should be written as a simple, readable exposition i.e., simple fact-giving language understandable by a large potential audience of average American schooling. Therefore, the recent tendency to achieve readers' interest by the use of glossy paper, four-color charts, pretty type and pictures, and fancy covers of plants and products will go for naught if clear language is not used to gain reader understanding.

The new trends in accounting terminology and form, as revealed in numerous 1946 corporate reports, for instance, Caterpillar Tractor Company, International Harvester Company, United States Steel Corporation, and Jewel Tea Company, were the most significant changes in statement presentation in recent years. Reports for the year 1948 will reflect more of these trends toward additional disclosure of facts, improved techniques and form, readable and purposeful reports, and a further acceptance of the corporate report as a good public relations document. Several excellent and stimulating articles in 1947 and 1948 have done much to assure this fact by challenging the dormant powers for improved reporting-writing of progressive accountants everywhere.[3]

REQUIREMENTS OF AN ANNUAL REPORT

Conclusions regarding desirable trends in reporting practices and requirements for adequate annual reports are tentatively advanced as follows:

1. Disclosure of Additional Facts
   - (a) More data about capital expenditures, employee insurance and pension plans, company's relations with labor unions, and the qualifications of company officers and directors;
   - (b) Information regarding company's efforts to improve employees' skills, to foster guaranteed wage plans;
   - (c) Comparison of current year's separated payroll with prior year or years;
   - (d) Breakdown of amounts expended for raw materials, supplies, labor, and other major expenses usually combined in a meaningless caption;
   - (e) Comparative balance sheets, statements of income, source and disposition of net current assets, and analysis of property accounts for periods of ten years or more (possibly best single example is the annual report of Caterpillar Tractor Company);
   - (f) Interpretative ratios on comparative statements.

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[3] See particularly William Blackie, "Financial Statements for Corporate Annual Reports," *Journal of Accountancy*, March, 1947; Aubrey Williams, "Trends in Accounting Terminology and Form Revealed by 1946 Corporate Reports," *Journal of Accountancy*, October, 1947; Don Knowlton, "Financial Statements need not be Failures as Public Relations Tools," *Journal of Accountancy*, November, 1947; Christian E. Jarchow, "Trends in Annual Reporting," *Controller*, September 1947.

2. Improved Techniques
   (a) Greater effort to make report more readable, purposeful and attractive by simple fact-giving language, by use of colors, by charts and graphs, and not too much text;
   (b) Use of first page of text for summary presentation of high spots of the report;
   (c) Use of improved and simplified terminology and form of the new single-step statement of financial condition and statement of operating results. Choice is often opinionated.
3. Improved Form of Financial Statements
   (a) The improved form of the balance sheet is no longer based on the old equation: assets equal liabilities plus capital; because it now uses the more readily grasped and purposeful equation: current assets minus current liabilities equals net working capital plus investments plus property and other assets minus fixed liabilities equals stockholders equity; or more simply, assets minus liabilities equals net assets in which capital was invested. See Exhibit I for an example of this type of statement.
   (b) The improved single-step form of a statement of income and expense must furnish the additional facts needed by its readers and also strive for simplicity in design by avoiding useless sub-totals and balances. This type requires all the items of income to be grouped together and all the costs of doing business to be grouped together and the latter deducted from the former total to give in a *single step* the net income for the period. However, some advocates of this type may not wish to go all the way, so an extra step is taken, for instance, to show *net income before federal income tax*, which does not interfere with the main idea. See Exhibit II for an example of this latter type of statement.
   (c) The improved form of a source and disposition of net current assets or net working capital is shown in Exhibit III.
4. Suggested Outline for a Modern Annual Report
   (a) The entire report should not be too long —no report should exceed 20 pages.
   (b) Outside cover page should be kept distinctive and attractive by use of artwork and colors.
   (c) Inside cover page should reveal list of directors and officers, preferably with pictures or brief statement of age, training and experience.
   (d) The text of the report should be a brief (first page a summary of high spots of report), simple exposition of the activities of the year and full use of color charts and graphs and fact-giving picture-words should be used to convey the story about the financial results of the fiscal year and other pertinent data on labor union relations, employee plans, future outlook toward sales and expansion in view of its position in its industry and the national economy. Try to avoid a lengthy text and keep within ten pages.
   (e) Two pages should be devoted to a statement of financial condition of the type suggested by Exhibit I.
   (f) One page should be used for a statement of results of operations and summary of net income retained in the business of the type suggested by Exhibit II.
   (g) One page should be used to explain the source and disposition of net working capital of the improved type suggested by Exhibit III.
   (h) The public accountant's audit certificate should come next as an affirmation of the accuracy of the figures in the report and presentation of statements based on accepted accounting principles.
   (i) The next two pages should show a five- or ten-year comparative statement of financial condition.
   (j) The next two pages should show a comparative five or ten-year statement of results of operations and summary of net income retained in the business.
   (k) The above statements should use analytical ratios adequately for ready interpretation.
   (l) One page should reveal a statement of detail of the property accounts, showing cost, depreciation, and book value with footnotes regarding insurable or replacement values based on reputable appraisals.
   (m) Institutional advertising on plants, number of employees, and products should go on inside and outside of back cover.
   (n) A completely styled report should embrace all of the points mentioned above; and the minimum requirements for an annual report should include only the above Exhibit I and II with a distinctive cover explaining location of plants and types of products manufactured.

EXHIBIT I

MAREMONT AUTOMOTIVE PRODUCTS, INC.

STATEMENT OF FINANCIAL CONDITION

Net Assets in which Capital Was Invested

CURRENT ASSETS			
Cash			$ 911,863
Accounts receivable (See Note No. 1)—			
Regular trade		$1,529,805	
Subsidiaries and branches		162,608	1,692,413
Inventories (Valued at lower of cost or market)—			
Raw material		$1,268,193	
Work in process and finished goods		1,135,973	
Manufacturing supplies, coal, etc.		210,393	2,614,559
U. S. Government Refund Tax Claims (See Note No. 2)			62,440
Cash surrender value of life insurance			35,378
Fire insurance claims			121,680
Other current assets			86,957
Marketable securities—At cost			3,900
TOTAL CURRENT ASSETS			$5,529,190
DEDUCT—CURRENT LIABILITIES:			
Accounts payable		$ 620,991	
Accrued liabilities—			
Salaries, wages and commissions	$152,206		
Federal income taxes	734,846		
Other federal and state taxes	169,527		
Other accrued liabilities	24,057	1,080,636	
Advance deposits from customers		21,000	
TOTAL CURRENT LIABILITIES			1,722,627
NET CURRENT ASSETS (net working capital)			$3,806,563
PROPERTY—AT COST:			
Building, machinery and equipment		$1,656,057	
LESS—Reserves for depreciation and amortization		723,280	
NET BOOK VALUE		$ 932,777	
Land		151,630	1,084,407
U. S. TREASURY BONDS IN ESCROW			10,000
INVESTMENT IN SUBSIDIARIES			53,430
DEFERRED CHARGES			90,533
TOTAL			$5,044,933
DEDUCT—DEBENTURE BONDS:			
4% Sinking Fund Debentures, due 12/1/60	$826,000		
LESS Sinking fund assets (See Note 3)	11,000	$ 815,000	
4% Sinking Fund Debentures, due 8/1/62	$500,000		
LESS Sinking fund assets (See Note 3)	15,000	485,000	1,300,000
NET ASSETS IN WHICH CAPITAL WAS INVESTED (Net worth)			$3,744,933

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of MAREMONT AUTOMOTIVE PRODUCTS, INC.

We have examined the statement of financial condition of Maremont Automotive Products, Inc., as of September 30, 1948, and the statement of results of operations and summary of net income retained in the business for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate. Our examination was made in accordance with generally accepted auditing standards and included all procedures which we considered necessary in the circumstances.

MAREMONT AUTOMOTIVE PRODUCTS, INC.

—At September 30, 1948

Sources from which Capital Was Obtained

Common Stock:	
Authorized 200,000 shares, par value $1.00	
Issued and outstanding 120,000 shares	$ 120,000
Paid-in Surplus (Paid in premium over par value)	633,000
Net Income Retained for Use in Business (Exhibit II)	2,991,933

Footnotes:

1. Reserve for Bad Debts:
The regular trade accounts are 93% current. No Reserve has been provided for Bad Debts, as the past experience indicates that no such reserve is necessary.

2. Contingent Assets:
The company has pending claims for refund of federal excess profits taxes under Section 722 relief provisions of the Internal Revenue Code. Hearings have been held, but the amount which may be refunded to us is not determinable at this time.

3. Debenture Bonds—Sinking Fund

Installment Requirements:
Under the provisions relating to the debenture bonds, due December 1, 1960, and August 1, 1962, the additional sinking fund installments required to be made within 120 days from September 30, 1948 is $40,000 for the debenture bonds due December 1, 1960, and $133,868 for the debenture bonds due August 1, 1962.

Contingent Liability:
The Company is a guarantor of notes payable in the amount of $333,750, issued by an associated company.

Total Capital Invested (Net worth)	$3,744,933

Independent Auditors' Report (Continued)

In our opinion, the accompanying statement of financial condition and related statement of results of operations and summary of net income retained in the business present fairly the position of Maremont Automotive Products, Inc., at September 30, 1948, and the results of its operations for the fiscal year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

GRAY, HUNTER, STENN & CO.
Certified Public Accountants

Chicago, Illinois, November 12, 1948.

ILLUSTRATIONS OF STATEMENTS

The illustrated form for a statement of financial condition or position could not be called a balance sheet in spite of the wide acceptance of this term due to the radical changes in form and terminology; the choice is between financial *condition* and *position*. In keeping with the conventional concept of a balance sheet as a *static* picture of the financial condition of a company at a given time, the word *condition* seems to connote a more final break-off point than does the word *position*. Hence Exhibit I is named the *Statement of Financial Condition*. Since the pattern of this type of a statement resolves itself into the net assets, the top center caption and the bottom balance (net assets) are entitled: *net assets in which capital was invested*. This type of a statement, naturally, eliminates showing the total assets, but it is readily obtainable by a quick mental or side computation. It does spotlight the more important figure of net working capital, an amount of prime importance to top management, grantors of credit, and investors. It is to be noted that two pages are used for Exhibit I to permit a division of the statement into two sections. The second section at the top is called *sources from which capital was obtained* and at the bottom the side caption is entitled *total capital invested* to denote the total stockholders' equity, thereby averting any confusion regarding the scope of *sources from which capital was obtained*. The open space of this second section, after use of detailed showing of the elements of the stockholders' equity which includes the cross reference to Exhibit II, namely, *net*

EXHIBIT II

MAREMONT AUTOMOTIVE PRODUCTS, INC.

RESULTS OF OPERATIONS AND SUMMARY OF NET INCOME RETAINED IN THE BUSINESS
For the Years Ended September 30, 1948, 1947, and 1946.

	Fiscal years ended September 30, *Amounts*			*% to Total Income*		
	1948	*1947*	*1946*	*1948*	*1947*	*1946*
TOTAL INCOME, including Net Sales and non-operating income............	$14,270,570	$12,700,881	$8,117,995	100.0%	100.0%	100.0%
COST OF DOING BUSINESS:						
Inventories brought forward from previous year..................	$ 2,076,175	$ 1,599,172	$1,021,834	14.5%	12.6%	12.6%
Cost incurred during year—Raw materials and supplies...........	6,143,605	5,856,426	3,666,082	43.1	46.1	45.2
Total Salaries, Wages, Social Security and Insurance Benefits.......	4,982,063	4,666,517	3,130,972	34.9	36.7	38.5
Sundry other operating expenses, such as perishable tools, depreciation, advertising etc............	1,610,746	1,406,086	1,209,508	11.3	11.1	14.9
Other non-operating expenses, such as interest paid, etc............	78,144	60,890	104,398	.5	.5	1.3
TOTAL......................	$14,890,733	$13,589,091	$9,132,794	104.3%	107.0%	112.5%
DEDUCT—Inventories carried forward to next year.............	2,404,166	2,076,175	1,599,172	16.8	16.4	19.7
COSTS ALLOCATED TO YEAR........	$12,486,567	$11,512,916	$7,533,622	87.5%	90.6%	92.8%
NET INCOME BEFORE FEDERAL INCOME TAXES.....................	$ 1,784,003	$ 1,187,965	$ 584,373	12.5%	9.4%	7.2%
DEDUCT—Federal Income Taxes.....	668,052	451,595	224,224	4.7	3.6	2.8
NET INCOME FOR YEAR...........	$ 1,115,951	$ 736,370	$ 360,149	7.8%	5.8%	4.4%
ADD—Net income for the past years retained in the business..........	2,049,974	1,403,604	1,085,455			
	$ 3,165,925	$ 2,139 974	$1,445,604			
DEDUCT—Dividends paid............	$ 120,000	$ 90,000	$ 42,000	.8%	.7%	.5%
Final write-off plant moving expenses	53,992	—	—			
	$ 173,992	$ 90,000	$ 42,000			
NET INCOME RETAINED IN BUSINESS SINCE INCORPORATION............	$ 2,991,933	$ 2,049,974	$1,403,604			

income retained for use in business from incorporation, is used for various necessary and explanatory footnotes of the statement.

Incidentally, the writer is cognizant of the violation of Accounting Research Bulletin No. 30, which excludes from current assets the included item in Exhibit I of cash surrender value of life insurance ($32,087) on officers' policies. There may be extenuating circumstances which require this item to be shown among the current assets. Possibly for a going concern concept the exclusion may de-emphasize liquidation values and emphasize intent too much; certainly some managements and bankers desire the item to be shown as current.

The selection of the title for Exhibit II, namely, *Results of Operations and Summary of Net Income Retained in the Business*, was a natural and logical outcome of an attempt to describe the events of the moving picture of the fiscal year's activi-

EXHIBIT III

MAREMONT AUTOMOTIVE PRODUCTS, INC.

COMPARATIVE SUMMARY OF FINANCIAL OPERATIONS
For Years Ended September 30, 1948 and 1947

	Year ended September 30, *1948*	*1947*
ADDITIONS TO WORKING CAPITAL:		
Net Income for the year	$1,115,951	$ 736,370
ADD—Depreciation of building, machinery and equipment	105,740	86,012
Issue of 4% debentures, due August 1, 1962	—	500,000
Premium on the above debentures	—	8,500
TOTAL ADDITIONS	$1,221,691	$1,330,882
DEDUCTIONS FROM WORKING CAPITAL:		
Additions to buildings	$ 2,890	$ 29,361
Additions to machinery and equipment	157,506	269,026
Additions to leased property improvements	15,337	800
Additions to office furniture and fixtures	13,678	31,016
Additions to deferred charges	24,515	18,358
Investment in associated companies	14,250	1,000
Retirement of debentures	84,096	105,904
Payment of dividends	120,000	90,000
TOTAL DEDUCTIONS	$ 432,272	$ 545,465
INCREASE IN NET WORKING CAPITAL	$ 789,419	$ 785,417
THIS INCREASE IS ACCOUNTED FOR AS FOLLOWS:		
INCREASE/(decrease) in current assets:		
Cash	$ 726,826	$ 108,352
Accounts receivable	(93,167)	519,954
Inventories	352,216	536,271
Cash surrender value of life insurance policies	3,291	3,097
Fire insurance claims	121,680	—
Other current assets	47,649	(19,586)
INCREASE IN CURRENT ASSETS	$1,158,495	$1,148,088
LESS—Increase/(decrease) in current liabilities:		
Notes payable—Bank	$ —	$ (100,000)
Accounts payable—Trade	35,561	222,190
Accrued liabilities	333,515	240,481
INCREASE IN CURRENT LIABILITIES	$ 369,076	$ 362,671
INCREASE IN NET WORKING CAPITAL	$ 789,419	$ 785,417

ties. To make this statement more informative, it was inevitable to combine the income and cost elements into separate groups and deduct one from the other to arrive at the net income. The former division of the cost elements into several possible meaningless sub-totals of profit is discontinued by this improved type of income and expense statement; all of the elements are necessary for the operation of the business. Hence, all of the costs of doing business (See Exhibit II) are grouped together and separated to give the comparative amounts on the pertinent expense subgroups of accounts as shown. No separate amount was shown in Exhibit II for depreciation (See Exhibit III), because the amount is fairly inconsequential ($82,609), otherwise it should be shown.

The single-step concept was changed slightly to permit the showing of Net Income before federal income taxes, because it is desired by our top management and bankers for the following obvious reasons: (1) management has no control over the income tax rate and hence the net income

figure which denotes their managerial efficiency must be shown before federal income taxes; (2) similarly, for five- or ten-year trend comparisons of the net income, the provision for federal income tax would have to be excluded due to varying rates over a cycle period; (3) while federal income taxes are obligatory payments, it is not the prime objective of doing business so top management and grantors of credit need to know the net income before federal income taxes; (4) federal income taxes are not usable for the determination of costs or prices of products. It is to be conceded, however, for the stockholder the resulting figure, *net income for year*, is the amount which determines, largely, the size of his dividend. To this net income amount is then added the net income for past years retained in the business, and deducted the dividends declared during the year to give *net income retained in business from incorporation*, which is the cross reference figure to Exhibit I.

Exhibit III has been mentioned previously. The statement is largely self-explanatory in this new elaborated form.

CONCLUSION

The accountant is also confronted with the possibility that over-simplification of financial statements might easily result in confusion rather than clarity. Hence, improvements in financial statements and annual reports may well be the result of trial and error and certainly requires the exercise of good judgement and knowledge if continued improvement is to be had; innovations for innovation's sake are not satisfactory. Therefore, the controller and the public accountant are presented with a continuous challenge and grave responsibility to make the annual report more valuable and informative by their influence on its content and preparation; only through these combined efforts will the annual report gain the confidence of the public, labor unions, the investors and top management.

THE ROLE OF ACCOUNTING IN MANAGEMENT[1]

R. W. Coleman

"THE SIGNIFICANCE of facts is more important than the facts themselves, and if we know the significance, we may even forget the facts." This thought, expressed by Oliver Wendell Holmes, seems pertinent when appraising the relation of accounting to management.

It is the managerial significance of business data that is really important. Ideally, the greatest aid that accounting could offer management would be to assist in the accomplishment of its objectives through the preparation and interpretation of appropriate statements. The techniques whereby business transactions are recorded and their values eventually placed in the statements are of secondary importance.

The relation between accounting and management has been commonly expressed by the phrase, "accounting is a tool of management." This means that it is possible for management, through the use of proper accounting reports, to make decisions and to formulate policies based on recorded business data.

The function of interpreting accounting records has been accepted by accountants. The American Institute of Accountants offers this definition:

> Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.[2]

Another significant statement from a publication of the American Accounting Association is as follows:

> In a changing economy, accounting has been undergoing a change. From a convenient mechanical device, privately applied to the measurement of the status and results of a business enterprise, it has grown into an important medium for the public expression of the important facts about our vast and complex commercial and industrial society. Where the accountant once was concerned merely with assisting the owners of a business to evaluate its operations in money terms, he now must recognize a broad social responsibility. His findings, and the manner in which he sets them forth, have become the basis for significant decisions and policies, not only in business affairs, but in economic, social, and political matters as well.[3]

These two statements, from authoritative groups, acknowledge the responsibilities of accountants to business management. The first recognizes the accountant's function of interpreting records; the second stresses his responsibility of informing not only management but others, such as employees, creditors, stockholders and regulatory bodies, of those facts which they should know. Because accounting is used as a means of communicating pertinent facts to management as well as to others it frequently has been termed the *language of finance.*

PRESENT STATUS

Studies have been made recently, however, which indicate that the accountant as an interpreter to the public of the *language of finance* would do almost as well were he to express himself in Greek. This has been strikingly disclosed by a study, *The Public's Acceptance of the Facts and*

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[1] This paper was presented at the annual meeting of the West Virginia Society of Certified Public Accountants at White Sulphur Springs, West Virginia, on October 29, 1948.

[2] American Institute of Accountants, *Accounting Research Bulletin No. 9* (Special), May 1941, p. 67.

[3] W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards* (Chicago: American Accounting Association, 1940), p. v.

Figures of Business Accounting. This report indicated that the public has an erroneous impression of the amount of profits made by business; that a substantial group does not understand business reports; and that despite certification and safeguards imposed by federal and state laws a considerable number distrust financial statements.[4]

Two pertinent conclusions may be drawn from this survey. First, about half of the American public does not see or understand financial statements prepared by accountants; and of those who do see the statements, about half believe in them. Second, business managers, on the basis of this and other surveys, may be excusably skeptical about the value of present accounting reports as a useful medium for informing the public.

The authors of the Survey have the following comment to make:

> The public acts, not on facts, but on what it believes to be facts. When people do not have the truth about business they are led to take points of view or support managements that hamper the functioning of the nation's economy.[5]

The fact that accounting is not rendering the aid to management that ideally it might may be attributable to several causes. They cannot be quickly remedied. Four of these causes require consideration: scope of the profession, uniformity of accounting procedures, lack of commonly understandable terminology, and the willingness of accountants to assume the responsibilities of their profession.

[4] Specific detail taken from this report includes the following: the average American thinks that business is making about 25 per cent profit; less than one-quarter of the people ever read financial reports in their newspapers; only one-third of the population has ever seen a profit and loss statement; 45 per cent believe they tell the truth, 14 per cent have no opinion; 56 per cent believe that companies make their statements difficult to understand and use too many technical terms. For a more complete account of this report, see Daniel J. Hennessy, "Why the Story Must Be Told" in *Telling the Business Story*, (New York: Controllers Institute of America, 1948), pp. 3–11.

[5] Ibid., p. 8.

SCOPE

Accounting practice has developed in response to a changing business economy. Twenty-five years ago it was a medium which primarily expressed the financial status and the results of operation of a business enterprise. Now it purports to express significant facts about public aspects of the business economy. From the professional point of view, this change has meant that not only the interests of management but also those of creditors, stockholders, wage earners, regulatory bodies, and other agencies must be considered.

In view of these changes, efforts have been made to clarify, redefine, and seek acceptance of accounting doctrine and practice. This has been no easy task, but for years the American Institute of Accountants, primarily practitioners, and the American Accounting Association, primarily teachers, have worked to this end. Their respective efforts have not led to the same conclusions.

Lack of agreement among accountants as to the province of the profession is complicated even further by the fact that it is closely related to other specialized fields. There have been conflicts with lawyers, for example, as to the proper jurisdiction of each profession in income taxation. In the Bercu case, the Supreme Court of New York, in March 1947, upheld the right of Bernard Bercu, an accountant, to prepare tax statements and to offer advice about tax matters. When the case was appealed, the Appellate Division of the Supreme Court, in April, 1948, reversed the decision, and held that the respondent's activity did not come within the proper scope of the accounting profession and constituted an unlawful practice of law. An order of the Appellate Division of the Supreme Court for the First Department, entered on September 24, 1948, made this decision final. It is doubtful whether this ruling has settled the conflict between accountants

and lawyers with respect to income-tax practice. Despite this decision, certified public accountants are premitted to practice before the United States Tax Court.

Similarly, there have been conflicts between accountants and appraisers.[6] The topic of depreciation may be cited as an example. To the accountant the problem of depreciation is one of placing a monetary evaluation on the decline in value of the asset (valued at purchase price) and, as such, treating it as a cost of obtaining revenue for the fiscal period. To the appraiser the problem is often one of determining the relative efficiency of an asset in use and comparing it with the efficiency of a new asset valued at the reproduction cost. These conflicts are significant. If the appraiser does not understand or recognize conditions that affect the valuation of assets for accounting purposes, the accountant must be aware of this situation, and must act accordingly.

One might well raise the question as to whether the field of business statistics may be properly included within the province of accounting. The analysis of accounting records, through the use of statistical methods, is a field in which great service can be rendered to management. Cost and profit controls and other operating statistics offer important opportunities for development by the accountant. Here again, however, is an area which will be disputed or usurped. The American Statistical Association has recently given special attention to this field. There is ample evidence that the statisticians will develop this area of analysis if the accountants fail to avail themselves of the opportunity afforded.

UNIFORMITY OF ACCOUNTING PROCEDURES

The desire for uniformity in accounting practices has undoubtedly affected the scope of accounting. It is clear why uniformity is so desired. In the analysis of financial statements proper standards of comparison are essential. In order for comparisons to be valid, the items compared must be comparable. Uniformity in accounting procedures exists to a marked extent but the practical difficulties in extending uniformity to all areas in accounting procedures are considerable. For example, despite all efforts, uniformity has not been achieved in the valuation of inventories and in the formulation of depreciation policies.

The insistence upon uniformity, as a goal, is undoubtedly an oversimplification of the whole problem of the analysis of accounting records. For different purposes different data are required, if the needs of management are adequately served. Records must be kept in such a way that they will meet the requirements of management.

The comments of George Oliver May on this subject are pertinent:

> Desire for uniformity is in part a vague, general yearning for rules which will eliminate (or at least obscure) the complexities and uncertainties of life. Uniformity should be regarded not as a goal but as a possible aid in making accounts more valuable, particularly to the unskilled reader with a legitimate interest in them whose claims to consideration are now generally recognized. If we could rely on all accounts being an interpretation of all the relevant facts according to the best judgment of honest and competent persons, exercised with an understanding of the purpose for which the accounts were to be used, uniformity would become of minor importance.[7]

TERMINOLOGY

An important obstacle to effective interpretation of financial statements to management and to the public is the lack of a commonly understandable language

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[6] See Clârence Crocheron, "Relationship of the Accountant and the Appraiser," *The Journal of Accountancy*, January, 1946, p. 29.

[7] George O. May, "Uniformity in Accounting," *Harvard Business Review*, Autumn 1938, p. 7.

which accountants can use for the groups they address. This is especially true when they address employees, stockholders and others who have not been trained in finance or accounting. It cannot be understood because the terminologies used are technical and confusing and because adequate efforts are not taken to explain in nontechnical terms what the statements mean.

Examples of words which are so loosely used as to be thoroughly confusing to the layman are easy to cite. Surplus, working capital, profits, and reserves are common illustrations. Until practicing accountants, controllers, and teachers of accounting can agree on the meaning of the terms used, improvement on the means of communication will be slow. Some progress has been made in clarifying terms. Much still remains to be done.[8]

When the story of the enterprise is told to employees, stockholders, and the general public, it must be presented in a manner that the reader can understand, otherwise the information will not be used. The writing is difficult—technical data must be expressed accurately and simply.[9] A scholarly attitude toward the preparation of financial statements coupled with an indifference to their popularization will result in the statements being neither understood nor used by the public. Some corporations are giving special attention to the preparation of annual reports written in language easy to understand and presented in an interesting way.[10] Some are even presenting financial and operating information by means of films.[11]

[8] See Editorial, *The Journal of Accountancy*, "The Need for Agreement on Basic Accounting Procedures," June 1947, p. 455.

[9] See John Mantle Clapp, "Accountants and Utilitarian Writing," *The Journal of Accountancy*, January 1946, p. 384.

[10] John Morrell and Company, United States Steel, Caterpillar Tractor, Burroughs Adding Machine Company, and the Rexall Drug Company may be cited as examples.

[11] For example, General Mills and Penn Mutual.

ASSUMPTION OF PROFESSIONAL RESPONSIBILITY

Despite a general recognition that the analysis of accounting statements is part of the proper scope of accounting, distinctions are sometimes made between the function of preparing statements and the function of analyzing them. The first function is, of course, accepted without question; the second is not.[12]

The fact that there is any question about including this function indicates that there are still members in the profession concerned more with the instruments of accounting than with its objectives. This condition has led to the accusation that accountants are too often tinkerers of records instead of professional men concerned with the solution of management objectives.

The accountant's usefulness to management is in direct proportion to the presentation of pertinent financial and operating data which help in solving its problems. Unless the accountant can develop techniques and procedures sensitive to these needs the assistance he can offer will be of limited use.

Dependence upon accounting traditions will not solve the problems. In fact, one may even question the usefulness of some of the underlying assumptions. The assumption that accounting values are based on costs may be cited as an illustration. The historic cost figure of an asset often bears little relation to its current value and hence is of limited use to management. For example, the records of a timber tract kept in the traditional manner make no allowance for accretion. As years pass and the timber grows, the recorded investment value remains the same. The accounting

[12] See Myron S. Kem, "The Use of Accounting in Business Policy Determination," The Accounting Review, October 1947, pp. 397–400. The author believes that it is the function of the accountant to prepare statements and the function of management to analyze them.

records will not disclose what the timber tract is worth.

It is likely that the profession of accounting will increase in public esteem only if accountants abandon their dependence upon traditional accounting procedure and willingly assume the responsibilities of interpretation, despite the difficulties involved. Failure to accept this responsibility will tend to have the effect of reducing accounting to routine procedures in which the quality of skilled judgment is of minor importance. It would seem only logical that the accountant, because of his training, experience, and knowledge of the sources of values should be in a position to analyze the statements prepared from the records. It is significant to note that certification is limited to the preparation of statements; it does not include an analysis of the statements so prepared.

Lawyers can offer no warranty that the cases they prepare and plead before courts will result in favorable decisions. Physicians continue to acquire flourishing practices without infallible records of their patients' recoveries. In neither case do these factors deter either profession from making specific recommendations.[13]

The profession has attempted to improve accounting practices. The American Institute of Accountants and the American Accounting Association, through research have sought to clarify issues confronting the profession. Some changes have been brought about through the influence of outside agencies. For example, the Securities Act of 1933, and the Securities Exchange Act of 1934, empowered the Securities and Exchange Commission to exercise extensive influence over accounting practices. It is widely conceded that the Commission has cooperated with experienced practitioners and, in general, has wisely prescribed financial reporting procedures and policies.

Any comparison of accounting with other professions, such as law or medicine, in terms of progress made or influence exerted on the public should not overlook the fact that accounting is a comparatively new profession. In this country accounting practice has been based upon the English tradition. Not until 1880 was a royal charter granted to the Institute of Chartered Accountants in England and Wales. Not until 1897, when the New York Certified Public Accountants was organized, was there a similar group in this country. Later in the same year, like organizations were formed in Illinois and Pennsylvania. In October of 1900, New York University was the first institution of higher learning to offer professional education in higher accountancy.

Comparative youth of the profession, however, cannot be offered as a convincing reason why accountants should hesitate to accept greater responsibilities in order to serve management. An aggressive, socially responsible leadership from within may well prevent changes forced by outside groups or agencies.

Possibly an initial step in the accomplishment of this objective would be for the leading professional organizations, in cooperation with an outstanding university to establish a graduate school in the profession of accounting. Its purpose would be to attract outstanding, enlightened practitioners and teachers who would address mature members from each group. Instruction and discussions would be held in order to aid members of the profession to widen their perspectives and to render greater service. This might well prove to be a landmark in the development of accounting as significant as that provided by New York University in 1900.

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[13] For further discussion of this point see L. B. McGladrey, "Problems in Assuming Proper Responsibility," The Accounting Review, July 1947, p. 280.

THE MEASUREMENT AND ADMINISTRATION OF INCOME

Rufus Wixon

The accounting concept of income as the residual of the matching of costs and revenue is one which appears on the surface to be rather innocuous. Its application, however, is known to be a difficult but also a delusive task. The accountant not only must decide which basis of revenue recognition is appropriate for a given situation and which costs have expired and are to be matched with this batch of revenue, but he must express this matching process in terms of money. Today we need only turn to our daily newspapers for a constant reminder that the dollar as a measuring device is not a stable unit. It is the purpose of this paper to demonstrate that this limitation of the accountant's measurement of income adds to the confusion which persists in the measurement and administration of income.

The almost daily statements in the press to the effect that the matching of historical costs against current revenue does not provide for the replacement of assets is indeed a truism. Certainly the accountant's measurement of income and management's use of the funds provided by revenue are truly independent activities! Yet a confusion between these two separate elements seems to be ingrained in the thinking of many individuals. The current propaganda to the effect that depreciation based upon historical cost does not provide for replacement of the assets which are expiring is the most striking case at point. Witness, for example, such statements as:

> "What the company comptroller is trying to do is to charge earnings with an equitable proportion of the cost of buildings or machinery over their useful life. This helps to provide a fund with which to replace such facilities when they wear out."[1]

Some of the confusion results from a misunderstanding of accounting terminology. For example, the terms "income" and "earnings" are used frequently to express the inflow of funds from the sales process. Obviously this connotation of the terms "income" or "earnings" is incorrect since income is a residual, a net amount after matching assets outflow against asset inflows. The quotation above is indicative of the misconception of the term "earnings." Depreciation is not a charge against earnings but rather a charge against revenue. In terms of physical flow, revenue is measured by the amount of assets coming into the business from the sales of products or services to customers. In turn, expenses are measured by the amount of assets going out of the business in this exchange transaction. Both revenue and expenses are expressed in terms of money. But since the value of the monetary unit is not a stable one, it follows that the matching process is not one of matching common dollar inflows and outflows. The discrepancy, of course, is greater in the case of expirations of long-lived assets as compared to short-lived assets. The residual, income, is a money income and not a real income.

Money income is affected by two factors, i.e., changes in the physical quantity of assets and changes in the price level. The accountant ordinarily is reluctant to recognize a rise in the value of assets due to a rise in their prices on the grounds that

[1] Stuart Chase, "How to Read an Annual Report," *The Lamp*, March, 1948, p. 23.

such gains are unrealized. But this recognition occurs at the time of sale during periods of rising prices inasmuch as asset inflows are expressed in terms of the current price level while the outflows, at least in part, are expressed in terms of the old price level. Thus, money income is inflated to the extent of the rise in the price level. Unfortunately some readers of the income statement assume that the income reported has actually been realized. They tend to confuse the matching of revenue and expense with the matching of receipts and disbursements. They apparently fail to realize that while revenue is measured by the inflow of current funds, expenses, on the other hand, may not be measured by the outflow of current funds. In other words, the assets flowing into the business from the sales transaction are expressed in terms of money and are also "money value" items since such assets are cash or receivables. But the assets flowing out of the business while expressed in terms of money are not "money value" items. Expenses are measured by the "cost" of the assets expired, and while "cost" may be defined as the outflow of funds, it must be remembered that such outflows of funds are a different exchange transaction from the sales transaction—a transaction which occurred at a different time when a different price level was in effect. They are asset transfers whereby cash is exchanged for merchandise, labor services, plant, etc. Such transactions, of course, are not a part of the accountant's matching process. Obviously since some of the assets received by these transfers are short-lived they are matched against revenue on a more current basis than others.

Another source of confusion is the duration of the cycle or period covered by the matching process. The cycle is completed by the accountant when revenues and the expired costs associated with these revenues are matched. Many individuals, however, tend to carry the accountant's cycle a step farther since they think in terms of the use of the inflowing assets from the revenue process as the means of replacing the assets which expired and were matched against this revenue. This, of course, is a problem of the use of asset inflows rather than one of measuring income. Admittedly it is a perplexing managerial problem in periods of rising prices inasmuch as management is responsible for seeing that the business continues as a going concern. This can only be accomplished if the flow of funds provides for the replacement of the expired assets. But to say that depreciation policy must provide for the replacement of the expired assets is erroneous inasmuch as it is not depreciation which provides the funds for replacement. Funds are provided from asset inflows rather than outflows, and asset inflows are expressed as revenue. Thus it is the revenue process which provides funds. What management is concerned with is the administration of revenue or asset inflows. In other words management must determine how much of these asset inflows will be needed for replacement of expired assets. When prices are rising a larger proportion will be needed for these purposes.

How does the measurement of income enter the picture? From the preceding analysis it is quite obvious that a failure to adjust the accountant's reported money income to real income acts as a multiplier in the managerial problem of administering income. For example, stockholders think of this money income as assets available for distribution and expect larger dividends. Customers feel the company is making too large a return and want lower prices. Employees look at this inflated income figure and demand higher wages. And, of course, the Treasury Department still takes its percentage of money income! Management, accordingly, is on the spot and the result has been seen

in the current income sheets of some of our major companies whereby the costs which expire in the matching process are expressed in terms of the money cost of replacing the expired assets while the unexpired assets reported on the balance sheet remain in terms of historical costs. This tends to remove from the reported income the "unrealized gains" resulting from rising prices. It is true that such methods may aid management from the standpoint of alleviating certain demands, but they produce a balance sheet which is even less meaningful than those which formerly existed.

What are the possible means by which this dilemma may be eliminated? One, of course, is to adjust to a common dollar. This would mean the elimination of the effect of purely price level changes on reported income. It is argued that a shortcoming here is the absence of a suitable general price level index. A more serious difficulty however, may be in the fact that the prices of all goods and services do not move in a similar manner, and there is thus the problem of deciding how much weight is to be given to each price or group of prices in the system selected. Another method would be to make a "fresh start" and revalue those assets which are out of line with current costs. This method has the advantage of dealing with the specific assets of a given company. In addition, it not only would result in matching against revenues current costs but also would present balance sheet figures more in line with the current financial position.

A further aid in eliminating the confusion between the measurement and administration of income would come from general use of the statements of funds in corporate reports. Its usage would indicate that regardless of whether one measures income by matching replacement costs or historical cost against revenue on the income statement, the use of funds still requires current outlays at current prices. Such a statement would call attention to inflows and outflows of funds during the current period and report to the various interested groups the problems of administering asset inflows. The conventional form of statement of funds, however, is of little use for this purpose since it merely adds to the confusion. This writer has seen only one form of this statement which is illuminating and that is the one suggested by Professor W. A. Paton.[2] In this form emphasis is placed upon revenue rather than income as a source of funds. Hence it is not necessary to add back such items as depreciation as a source of funds which is so commonly done in the conventional form. By way of illustration let us assume the following situation:

The X Company for the year ended December 31, 1948, submits the following conventional statements using conventional cost figures, i.e., depreciation based upon original cost and inventories determined by use of FIFO:

X Company

Comparative Balance Sheet
December 31, 1947 and 1948

Assets	*1947*	*1948*
Cash	$ 500,000	$ 450,000
Accounts Receivable (net)	1,500,000	1,800,000
Inventories (FIFO)	2,000,000	2,500 000
Land	100,000	100,000
Buildings and Equipment (net)	3,000,000	3,500,000
	$7,100,000	$8,350,000
Equities		
Accounts Payable	$1,500,000	$2,000,000
Other Current Liabilities	500,000	800,000
Capital Stock	3,000,000	3,000,000
Earned Surplus	2,100,000	2,550,000
	$7,100,000	$8,350,000

[2] See W. A. Paton, *Essentials of Accounting*, (New York: The Macmillan Company. 1938), pp. 798–805.

X Company

Income Statement
For the year ended December 31, 1948

Sales		$8,000,000
Expenses:		
Manufacturing Cost of Sales	$6,000,000*	
Distributing and General Operating Costs	800,000	
Federal Income Taxes	450,000	7,250,000
Net Income		$ 750,000
Dividends		300,000
Income added to Earned Surplus		$ 450,000

* Includes depreciation of buildings and equipment, $300,000.

The conventional statement of funds prepared from the above information would appear as shown at top of second column. If, however, we were to follow the form suggested by Professor Paton we would have:

X Company

Statement of Funds
For the year ended December 31, 1948

Sources		
Net Income	$ 750,000	
Add: Depreciation	300,000	$1,050,000
Decrease in Net Working Capital		50,000
Total Funds Available		$1,100,000
Application		
Increase in Buildings and Equipment		$ 800,000
Dividends		300,000
Total Funds Applied		$1,100,000

Comparison of these two fund statements reveals that the conventional form starts with income as a source of funds and adds back depreciation. The Paton form starts with the main source of funds (revenue) and shows step by step what has happened to these asset inflows. Depreciation is

X Company

Statement of Funds
For the year ended December 31, 1948

Revenue	$8,000,000
Current Outlays for Expenses and Taxes	6,950,000
Earnings available before dividends	$1,050,000
Dividends	300,000
Balance of Funds from Operations	750,000
Cost of Additions to Buildings and Equipment	800,000
Decrease in Net Working Capital (see Comparative Schedule of Working Capital)	$ 50,000

X Company

Comparative Schedule of Working Capital
Years ended December 31

	1947	*1948*	*Increase Decrease**
Current Assets:			
Cash	$ 500,000	$ 450,000	$ 50,000*
Accounts Receivable	1,500,000	1,800,000	300,000
Inventories (FIFO)	2,000,000	2,500,000	500,000
Total Current Assets	$4,000,000	$4,750,000	$750,000
Current Liabilities:			
Accounts Payable	$1,500,000	$2,000,000	$500 000*
Other	500,000	800,000	300,000*
Total Current Liabilities	$2,000,000	$2,800,000	$800,000*
Net Working Capital	$2,000,000	$1,950,000	$ 50,000*

excluded from the statement because it does *not* represent a use of current funds. This avoids the necessity of adding it back to net income with the implication that it provides funds! The clear-cut advantage of the form presented by Professor Paton should be apparent to any reader. Management with this statement can show what has happened to the asset inflow of the year in terms of the current year's demands. It is obvious from the statement that the X Company's net working capital has been impaired by the past year's use of funds. The fact is brought out to all interested readers that even though the company's earned surplus increased $450,000 as a result of money income retained, the company has $50,000 less in working capital than it had at the end of the previous year.

Suppose, however, that the X Company in its income sheet has reported depreciation in terms of replacement cost rather than original cost. Assume, for example, that the depreciation figure would then be $600,000 rather than $300,000. Using this amended figure the income statement would be recast as follows:

X Company

Income Statement
Year ended December 31, 1948

Sales		$8,000,000
Expenses:		
Manufacturing Cost of Sales	$6,300,000*	
Distributing and General Operating Costs	800,000	
Federal Income Taxes	450,000**	7,550,000
Net Income		$ 450,000
Dividends		300,000
Income added to Earned Surplus		$ 150,000

* Includes depreciation of buildings and equipment, $600,000.

** Income tax remains unchanged inasmuch as under existing tax laws depreciation cannot be based upon replacement cost.

Now what is the effect on the Statement of Funds?

X Company

Statement of Funds
Year ended December 31, 1948

Revenue	$8,000,000
Current Outlays for Expenses and Taxes	6,950,000
Earnings available before dividends	$1,050,000
Dividends	300,000
Balance of Funds from Operations	$ 750,000
Cost of additions to Buildings and Equipment	800,000
Decrease in Net Working Capital	$ 50,000

Obviously this change in the method of assigning depreciation cost against revenue has had no effect on the source and application of current funds. The higher depreciation charge has not provided one cent of additional funds!

Now suppose further that the $800,000 outlay for additions to buildings and equipment had not been made in the current year. Then the statement of funds would disclose an increase in net working capital from operations of $750,000 regardless of whether or not depreciation was taken on replacement cost or original cost. Management's problem thus remains one of judicious use of the funds provided from revenue. If it is necessary to expend $800,000 in the next period for plant additions, this fact might be projected on the statement of funds as follows:

Increase in Net Working Capital	$750,000
Estimated Funds Needed for Plant Additions	800,000
Estimated Decrease in Net Working Capital	$ 50,000

This projection of the statement might be more effective than the conventional earmarking of earned surplus through the use of the "Reserve for plant extensions" account as a method of informing investors of the needs for the retention of funds to safeguard their investment.

This statement of funds is not to be confused with the statement of receipts and disbursements. It is not concerned with just the inflows and outflows of cash, but

rather focuses attention upon the changes in working capital position. Accordingly it is essential that the statement of funds be accompanied by a comparative schedule of working capital to point out the changes in working capital position. It is entirely feasible that in a period of rising prices any increase in net working capital would be tied up entirely in inventories because of the necessity of replacing stock at higher prices. The use of LIFO, of course, will not disclose this fact in the comparative schedule since the inventories in terms of dollars will tend to remain at a fixed sum (assuming a constant volume). If LIFO is used, however, the effect will be to reduce the amount of funds derived from operations on the statement of funds because of charging against revenue a higher cost of goods sold. Thus, if we assume in the above case of the X Company that the entire increase in inventories at December 31, 1948, is represented by price increases rather than quantity increases, the effect on the statement of funds would be as shown in adjoining column and below.

the fact that the expenditure for the replacement of stock has been made from current funds and has been charged against the revenue of the current period. Thus even though the goods actually on hand are likely to be those most recently acquired or produced, the comparative schedule of working capital reports an historical cost figure for the inventory while cash has been decreased or accounts payable increased in terms of the current cost. Unquestionably LIFO is an aid to management in this respect *when prices*

X Company

Statement of Funds
For the year ended December 31, 1948

Revenue	$8,000,000
Current Outlays for Expenses and Taxes	7,450,000
Earnings available before dividends	$ 550,000
Dividends	300,000
Balance of Funds from Operations	$ 250,000
Cost of additions to Buildings and Equipment	800,000
Decrease in Net Working Capital (see Comparative Schedule of Working Capital)	$ 550,000

X Company

Comparative Schedule of Working Capital
Years ended December 31

	1947	*1948*	*Increase Decrease**
Current Assets:			
Cash	$ 500,000	$ 450,000	$ 50,000*
Receivables	1,500,000	1,800,000	300,000
Inventories (LIFO)	2,000,000	2,000,000	—
Total Current Assets	$4,000,000	$4,250,000	$250,000
Current Liabilities:			
Accounts Payable	$1,500,000	$2,000,000	$500,000*
Other Current Liabilities	500,000	800,000	300,000*
Total Current Liabilities	$2,000,000	$2,800,000	$800,000*
Net Working Capital	$2,000,000	$1,450,000	$550,000*

The effect here, it can be seen, is different from that of charging depreciation at replacement cost because the inventories are part of working capital. The decrease in net working capital is accounted for by *are rising*. But, on the other hand, it will work in an opposite manner *when prices are falling*.

To summarize, efforts should be made to clarify the fact that the measurement of

income and the flow of funds are not one and the same. Neither is the accountant's concept of income as the residual of a matching of asset inflows and outflows one of matching this period's inflows against the next period's outflows. To consider it such makes periodic reckoning more of a matter of conjecture than it now is. The confusion between the measurement of income and administration of income will persist as long as methods are employed which either intentionally or unintentionally are designed for this purpose. The central problem in accounting remains as one of developing the means of measuring real income rather than money income. Until this problem is solved satisfactorily, however, the difference between the measurement of money income and the flow of funds should be emphasized.

THE CHAMBER OF THE CITY OF LONDON, 1633–1642

MELVIN C. WREN

IN THE SEVENTEENTH CENTURY the chamber of London was something more than a city treasury. Indeed, its primary function, the care of orphans' funds, was more social than economic. In the period before the rise of banking, the chamber was an important lending institution, a source of working capital for the trading companies and merchants of the city. Its effect upon national expenditure, while indirect, was at times considerable, for money lent by individuals to the king was often borrowed from the chamber by citizens whose money was tied up in commercial ventures. On the other hand, it provided an investment outlet on a short-term basis when the city, needing cash for the management of its own affairs, occasionally must borrow at four to eight per cent for six months or a year. And of course it served the usual function of a city treasury in receiving taxes, fees, fines and rents and in paying salaries and maintenance costs.

The chamberlain, one of the city's chief officials, received and paid out funds and kept careful account of his stewardship, which was subjected to audit each year by a committee of citizens headed by the lord mayor. All payments out of the chamber, other than those such as salaries which needed no sanction, must be approved by the court of aldermen, the legislative body made up of the aldermen from each of the city's twenty-six wards. Payment of large sums of an unusual nature must be passed upon by the court of common council, the lower house of the London legislature composed of some two hundred and twenty members elected by the citizens in the precincts into which each ward was divided. The chamberlain's accounts are still in existence from the year 1633 to the present time.[1] There is internal evidence of the preparation of the annual accounts as early as the reign of Henry VIII, and the probability is that they go back much earlier. Whether the earlier accounts were destroyed in one of the fires that periodically devastated London is not known.

An examination of the account for 1633 and a reference to later accounts will indicate the sources of revenue upon which London depended and the uses for which the income was expended.

Each account covers a fiscal year, which began at Michaelmas. Prefixed to each annual account was a schedule of rents from the various real properties belonging to the corporation and scattered over the one square mile which was the city of London. The schedule describes every property, names the tenant and, where the property was held under lease and not rented on an annual basis, indicates the life of the lease. Six hundred and seventy properties are enumerated and described, and the information is repeated with the same care in every account. Rents are grouped according to the district in which the properties lay. After listing and subtotalling these receipts from "the general lands," the schedule continued with an enumeration of receipts from properties which had been bequeathed to the city, and the income from which was devoted, according to the terms of the bequest, to

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[1] City Account Books, MSS. deposited in the Record Office of the City of London. Volumes I–IV in Series 1 cover the period from 1633 to 1642. I am grateful to Mr. P. E. Jones, Deputy Keeper of the Records of the City of London, for making available to me the manuscript materials in his care.

certain charities. Here, among others, are noted the receipts from "the lands of John Costen, deceased, lying and being in Mark Lane, Well Alley, Pickaxe Alley, and Fenchurch Street, which he bequeathed in consideration that the owners thereof should forever distribute and give to the parish of All Saints Stainings forty bushels of charcoals weekly from Allhallowtide until Easter." The rent income in 1633 from "the general lands" was £2,080, that from bequests £949. Both figures were very close to the ten-year average.

The annual account of the chamberlain was divided into receipts or "the charge" and disbursements or "the discharge." First under the charge were listed the total receipts from real estate rentals, those from bequeathed properties being itemized separately. Fees received for the enrollment of apprentices and for the admission of freemen appeared next. A sub-total was then taken of all rentals and fees, and in it was included "the foot" of the last year's account, or the debit balance of the previous statement.

The next category of receipts noted in the charge was that from "rent farms," *i. e.*, payments or "rentals" made by various city officials for the right to charge certain fees at the city's markets. There were listed such items as receipts

"from the searchers and sealers of tanned leather for sealing of leather at Leadenhall market, £10; from John Massingbeard for the farm of the office of package of woollen cloths, £66 13s 4d; from John Varham and William Turner for gauging of fish, £4; from Roger Hatton for the farm of the office of garbling of spices, drugs and other merchandises, £50; from Robert Smith, measurer of linen cloth and mercery wares, for the farm of the said office, £50."

Receipts from rent farms, which differed slightly from year to year because some office-holders preferred to pay for two or more years at a time, totalled £689 in 1633 and averaged £676 over the decade.

There followed a group of miscellaneous revenues or "casual receipts ordinary," including the entries:

"Received of brewers, innholders and tiplers, for fines for breaking their assize of victuals, £11 6s 4d; of the wardens of the Company of Merchant Tailors for suffering the butchers strangers to use their art, 13s 4d; for pickage at Bartholomew Fair in Smithfield this year, £23 10s 11d; of Henry Hodges for so much by him received of foreign butchers for their standings with their flesh in Cheapside on market days, 40s."

This category produced £262 in 1633, and averaged £111 over the ten-year period.

The city received a very small income averaging less than ten pounds per year, from fines for violations of ordinances and customs regulating city markets.

A group of revenues named "leases, incomes, arrearages, rents and venditions" included occasional collections of arrears of rent, but was made up chiefly of "fines" for leases of offices or of properties. The fine was a premium paid for a lease or grant. It was usual for property rents to continue generation after generation at the same figure, some of them being fixed by law or by custom. As values rose, adjustment in rents was made by demanding a fine or initial premium when a new lease was issued. Among others, there were noted receipts

"from James Silverlock for his fine to be admitted to the office of one of the ten sea-coal meters, £50; from Robert Woodford in part payment of £100 by him due for a fine for the lease of a tenement in the parish of St. Michael Bassishaw, £20; from Theophilus Bolton, part of £200 for his fine for the lease of a tenement near Leadenhall, £100."

The total of this group varied considerably from year to year, according to the number of leases maturing and redrawn, each of which involved a fine, but the income of £480 in 1633 was near the decade's average of £491.

An interesting and a very important source of income to the city was that called "receipts extraordinary" consisting, as its

title suggests, of sums received by the chamberlain only once or a few times from particular individuals. The first forty-five items in this group in the 1633 account consist of interest income on loans made to merchants and trading companies, of which the following is a selection:

> Received of the Governor and Company of merchants trading to the East Indies, for interest on £4,000 lent to them for twelve months at six per cent per annum ending July 20, 1633, £240; of the said Governnor and Company of merchants trading to the East Indies for interest on £5,000 lent to the same for twelve months at six per cent per annum ending August 18, 1633, £300; of the same for interest on £4,000 for twelve months at six per cent per annum ending July 22, 1633, £240; of the same for interest on £4,000 for twelve months at six per cent per annum ending August 17, 1633, £240; of the same for interest on £3,000 for twelve months at six per cent per annum ending May 6, 1633, £180; of Sir Maurice Abbott (who was Governor of the East India Company), Henry Garway and William Garway, for interest on £4,000 for twelve months at six per cent per annum ending July 14, 1633, £240; of Nicholas Crispe for interest on £1,000 for twelve months at seven per cent per annum ending September 20, 1633, £35; of Sir Robert Naper and Sir Maurice Abbott for interest on £1,400 for twelve months at seven per cent per annum ending May 18, 1633, £98.

The great majority of names of borrowers were those of aldermen or common councilmen of London. The inference to be drawn is not so much that the chamber favored loans to city officials, but rather that men important in trading circles rose to and accepted important positions in city government. However it may be judged, obviously the tie between trade and city government was very close.

It is interesting to note the way in which a merchant spread his risk in several ventures. Sir Maurice Abbott was involved in the five loans made to the East India Company, but joined with Henry and William Garway in a sixth enterprise, and with Sir Robert Naper in a seventh. Many of these loans ran not for one year but for many, being renewed over and over again. For example, the East India Company renewed its notes each year and was in debt to the city chamber to the amount of £20,000 from 1633 to 1635, £17,000 from 1636 to 1638, £9,000 in 1639, and £4,000 in 1640 and 1641. The loan of £4,000 to Sir Maurice Abbott and the Garways ran from 1633 to 1642. As the Civil War drew on, the city reduced its loans receivable, needing the money for war preparations. The total amount of money on loan to individuals and companies in 1633 was nearly £130,000. For £38,000 of this the city held mortgages on land. The rest was unsecured.

Other items falling within the classification of receipts extraordinary included: money received from various livery companies which had been assessed in 1628 to pay the cost of the pageant at the time of the king's coronation; receipts from a tax upon citizens for repairing the gate and prison at Newgate and for improving distribution of water in the city; fines, one for as much as £100, levied upon individuals who had married orphan wards of the city without the consent of the court of aldermen; money borrowed "for the city's use"; and contributions received by the city which were to be used for the relief of non-beneficed clergymen who preached at the cross in St. Paul's churchyard. The total of the receipts extraordinary in 1633 was £5,444, the average from 1633 to 1642 £8,275.

The next group of receipts recorded in the annual account consisted of payments into the chamber of loans receivable plus accrued interest, and also of "fines for alderman and sheriff." Any freeman whose lands and/or goods were of the value of £10,000 or more was eligible for election to either office, or might be appointed one of the two sheriffs by the lord mayor. Election was a high honor, to which were attached certain perquisites, but service,

particularly in the office of alderman, was a heavy burden. It was possible to avoid serving by paying a fine of £400 if chosen to the office of sheriff and from £400 to £800 if to that of alderman. At times the lord mayor deliberately nominated for sheriff men who were known not to want the office, in order that the chamber might be replenished with the fines.[3]

The last group of receipts noted in the chamberlain's account was of money deposited in the chamber by will of a deceased citizen who left his estate to a child. This was the famous "orphans' fund," of which the city was trustee during the heir's minority. The child became the city's ward, and the court of aldermen ordered payments from the chamber for board and lodging for the child, and payments for the ward's education. If the child were a boy he was apprenticed out to a master at the proper age. If the ward were a girl, her bridegroom must be approved by the court of aldermen. When the heir reached legal age his portion, upon which in the meantime the city had allowed interest of six per cent, was paid over to him by the chamberlain. £16,842 was deposited to the orphans' fund in 1633, not far from the ten-year average of £16,722.

The receipts of the chamber for 1633, and the ten-year average, may now be listed, noting only the categories into which the accountant arranged them.

Receipts of the Chamber of London

	1633	*average 1633–1642*
Rent income, general lands	£ 2,080	£ 2,072
Rent income from bequests	949	953
Fees for enrollment of apprentices	404	348
Fees for admission of freemen	1,057	821
Rent farms (leases of market rights)	689	676
Casual receipts ordinary	262	111
Fines (penalties)	7	9
Fines (premiums) for leases	480	491
Receipts extraordinary	5,444	8,275
Sheriffs' fines and payment of loans receivable with interest	35,649	20,966
Deposits to orphans' fund	16,842	16,722
	£63,863*	£51,444

Under title of "the discharge" the chamberlain noted the disbursements during the year, again grouping them in convenient categories.

First of the expenses listed was the payment of "salaries" to three clergymen of city churches who were asked to preach at particular functions attended by the lord mayor and aldermen. The amount hardly varied from year to year, averaging £61 for ten years.

The second group, rent expense or "rents and quit rents," included payments: for rent of land on which stood the Royal Exchange, the pesthouse, and the water conduit just outside the city; for water piped into the Guildhall and into various residences furnished to city officials; and for rent of a wharf on the Southwark side of the river for the city's use. Total rent expense, £160 in 1633, remained constant for several years at a time, but changed radically from one period to another.

A group of expense items called "inward fees" consisted of payments of salaries to certain city officials. The recorder was paid £80, the chamberlain £50, the common sergeant and the comptroller of the chamber £40 each. The lowest salary was £8 13s 4d, paid to the sword-bearer's "man" and to the common crier's "man." The common hunt received several fees, as noted by the chamberlain's account:

> "to Gregory Oldfield, common hunt, for his year's fee, £10; and more to him in consideration of his house for his better relief, £5; and more to him toward his charges in keeping the city's kennel of hounds, £14; and more to him for keeping a long-winged hawk and a kennel of good spaniels, £3 6s 8d."

The total of the inward fees in 1633 was £883, and precisely the same amount was paid in each of the ten years examined.

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[3] Thirty-nine were fined £400 each for the office of sheriff between April 30 and August 27, 1639. Tradition has it that the present Mansion House, the residence of the lord mayor, was built in 1715 with sheriff's fines.

* Omitted the balance brought forward, which would bring the total up to £98,119.

Payments to various skilled and unskilled workers regularly employed by the city were recorded in the group of expenses called "outward fees." The city carpenter, city plumber, mason, bricklayer, printer, drummer, bell man, barge master and mender of clocks received regular fees, as did legal counsel retained by the city. Ringers of market bells, cleaners of sewers, keepers of conduits, and weighers at city scales also figured in the list, as did various pensioners. The amount so paid in 1633 was £667, slightly under the ten-year average.

Weekly wages of workmen, such as plumbers, plasterers, masons, carpenters and laborers, casually hired to keep the various city properties in repair, were set apart in a distinct group, the cost of such labor in 1633 totalling £745. The average for the decade was £874.

Building supplies—bricks, tile, lumber, lead, pipe, nails, hinges, glass and the like—cost the city £1,072 in 1633 and averaged £1,239 for ten years.

The next group of expenses, called "extraordinary works," included unusual repair and replacement costs. Gravelling the walks in Moorfields, rebuilding part of a city gaol, repairing the city wall, extending the distribution of water—of such costs was this group composed. Expenditures for this purpose in 1633 ran to £1,221 half again as much as the 1633–1642 average.

Under the title "necessary charges and expenses of divers kinds" were included costs such as: repairing and refashioning the city's plate; new banners for the city trumpeters; a dinner for the auditors of the annual account; fuel for use at the Guildhall; boots for certain workers on the city payroll, eleven of whom were provided with footwear as part of their pay; and "a new chair for Mr. Chamberlain." Such costs, which might be called incidental Guildhall expenses, amounted to £225 in 1633, which was slightly higher than was usual.

The next group, called "foreign charges," included a variety of expenses, some of them ordinary and recurring, others which would occur only once. Here are such items as payments: to the parish clerks for weekly reports of christenings and burials; to porters, pages and barge masters by way of tips when the lord mayor was knighted; to special pleaders in suits at law to which the city was party; to the poor in certain city parishes; and to printers and stationers for office supplies. Here are payments for bounty on otters' heads, toward there pair of St. Paul's Cathedral for barge and horse hire, and of impost on fifty tuns of wine given to the lord mayor and aldermen each year. The costs of journeys by city officials on city business are set forth in rich detail, even to a half crown paid "to a young maid who came there with a basket of cherries" when the lord mayor and aldermen visited the queen at Richmond. Unusual costs which appear in later accounts but not in that for 1633, such as making up deficits in ship-money levies that individual taxpayers refused to pay, and expense of military preparations as the civil war approached, should not have been paid by the city but by individual citizens. The foreign charges varied between a low of £4,394 in 1638 and £36,241 in 1639, the ten-year average of £12,183 being £4,500 more than was paid out in 1633.

Annual gifts at the New Year, of cash or wine or loaves of "double refined sugar," were made to various royal officials, and four tuns of wine were allowed to the lord mayor. The cost of such gifts in 1633, £175, was slightly above the average for the period.

Various crown and city officials received gifts of "winter livery" or official gowns to be worn on state occasions. Others received money in lieu of the gowns. This expense cost the city, on the average, about £346 a year.

The category called "allowances" in-

cluded fees allowed to clerks in the chamberlain's office for drawing up the annual account, deductions for "base and counterfeit" money paid into the chamber, and repayments made to apprentices who had been overcharged for enrollment under a master. A considerable item provided for deductions from rents earlier supposed to be collectible but now written off because the tenant "died very poor" or left the city. Allowances in 1633 totalled £106, but the ten-year average was three times as much.

The next group of issues is that of money lent out of the chamber to individuals and companies at interest for six or twelve months. Sums lent amounted to: £28,330 in 1633, £15,784 in 1634, £18,902 in 1635, £16,300 in 1636, £1,900 in 1637, £2,400 in 1638, £10,651 in 1639, none in 1640, £400 in 1641, and £2,740 in 1642. Of the £28,330 lent during 1633, £12,200 was lent at seven per cent, £10,550 at six and a half per cent, £1,700 at six, £1,500 at five, £1,500 at three and a half, and £880 was lent interest free. Money on loan at such rates would bring the city an interest income of £1,769 per year, while its payment of six per cent upon the money to orphans would cost the city £1,730. The court of aldermen, which must approve all loans from the chamber, exposed itself to criticism in not charging at least as much as it paid and so permitting the standing debt, perennially a worry after 1625, to continue to rise.

Payment to orphans who had reached maturity during the year of the money held in trust for them by the city was the next category noted in the annual account. The amount so paid over in 1633 was £20,258, slightly above the ten-year average.

Then followed money paid out for "orphans' findings," the term used to indicate the cost of "finding" or providing lodging for the orphan during the period of minority. Money paid out to various citizens in whose homes such orphans lived amounted in 1633 to £8,281. The average for the decade under review was £7,941.

Designated charities, for which bequests of land had been made to the city, cost about the same each year, about £120.

The last group of payments listed in the annual account included the costs of maintenance of the lands belonging to the lordship of Finsbury, which the city leased from the dean and chapter of St. Paul's. While the city obtained a rent income of £205 per year from these lands, it paid out about £100 to maintain them.

A summary may now be made of the expenditures in 1633 and of the averages for the decade, the groupings made by the chamberlain being retained in the following statement:

Disbursements from the Chamber of London

	1633	*average 1633–1642*
Rent expense ("rents and quit rents")	£ 160	£ 83
Wages and salaries		
Salaries of clergymen	63	61
Salaries at Guildhall ("inward fees")	883	883
City salaries other than Guildhall ("outward fees")	667	688
Weekly wages	745	874
Building supplies and materials	1,072	1,239
Repair and replacement costs	1,221	820
Incidental Guildhall expenses ("necessary charges and expenses of divers kinds")	225	156
Extraordinary expenses ("foreign charges")	7,683	12,183
New Year's gifts	175	154
Gifts of livery cloth and money	339	346
Allowances	106	313
Money lent at interest	28,330	9,741
Orphans' money returned	20,258	19,007
Orphans' findings	8,281	7,941
Charities: payments made from income on bequests	114	119
Payments out of the rents of lands of the lordship of Finsbury	112	99
	£70,434	£54,707

When the receipts and disbursements for 1633 are compared, it will be seen that revenue failed by £6,571 to cover expenditure. It may be noted, too, that average

income over the decade fell short by £3,263 of meeting average outgo.

The chamberlain appended to his annual account a schedule of all debts owing to the city, classifying them as loans receivable, unpaid fines for alderman and sheriff, unpaid fines for leases of city lands, and unclassified or "other" debts.

Under loans receivable are shown the name of the borrower, maturity date of the loan, the principal, rate of interest, and interest accrued on every note in the chamberlain's file. Here are loans past due for as far back as 1616, although the number is remarkably small. The amount owing to the city in 1633 on loans receivable was £129,221 in principal and £17,523 in unpaid interest, £146,744 in all. Of this amount, £44,000 in principal was money borrowed from the chamber by individual Londoners who had lent the king £60,000 in 1625. Another £5,000 in principal and £2,000 in interest were on loans that were past due and not renewed. Many of them were being paid off bit by bit. The rest of the loans may be considered as current. Loans receivable plus accrued interest amounted to £146,744 in 1633, £142,877 in 1634, £132,383 in 1635, £124,090 in 1636, £117,607 in 1637, £116,678 in 1638, £92,473 in 1639, £80,332 in 1640, £70,523 in 1641, and £70,019 in 1642. The average was £109,373.

The next class of debts owing to the city was of those arising from fines for the office of alderman and sheriff, of which over £7,000 were outstanding in 1633. It was usual for these to be paid in installments, but £1,200 of them were six years or more old, one going back to 1619. The amount of such debts outstanding in 1639 and 1640 was over £22,000.

Debts arising out of fines for leases were owing to the city in 1633 to the extent of £812, but in 1642 as much as £3,731 was owed on such account. Like the fines for city office, these amounts were paid off in installments.

An examination of various "other debts," which totalled £17,077 in 1633, reveals several items of interest. The largest item for £9,335, was the amount paid out of the chamber to meet the cost of putting twenty ships to sea in 1626 in the war against France. The £18,000 which the ships cost was levied upon householders, but they refused to pay to the extent of £9,335 and the amount was "borrowed" from the chamber until the tax could be collected. It never was collected, the same amount appearing in the accounts every year through 1648. It was carried on the books until 1655, along with other ship money uncollectible in the city, after which it was regarded as "desperate" or hopeless. Of a different nature were debts totalling £4,672 which arose by the city's payment of coat and conduct money for troops pressed for the army between 1624 and 1628. The exchequer should have reimbursed the city, but did not do so, These debts, too, were carried until 1648, after which they were included in the "account for martial causes," along with costs of the civil war. After 1655 they no longer appear in the annual account. In this category, too, are noted arrears of £497 of rents on city lands prior to 1625. They were carried up to the 1636 account, in which they appear with the marginal notation: "not thought fit to be any longer entered hereafter." After enumerating a score of small debts of varying age but still hopefully carried as "sperate debts," the chamberlain closes this category with the words: "also divers other debts owing to this city as in the thirteenth account [1615] of Mr. Cornelius Fish, late chamberlain, appeareth, which are not thought fit to be continued any longer from account to account."

Finally, the chamberlain enumerated the debts owing by the city, of which only one, the largest, may be noticed here. The

city in 1633 was holding in trust for orphans approximately £180,000. The amount declined slowly until 1648, and then fell sharply during the Cromwellian period, going below £100,000 in 1658. After the restoration it rose again to the pre-Civil War normal.

The chamberlain's accounts for the decade preceding the outbreak of the Civil War reveal the sources and volume of revenue enjoyed by London, and the uses for which that revenue was spent. An examination of these accounts seems to justify certain conclusions.

During the decade under review the city was running into debt at the rate of over £3,200 a year, and that in spite of a studied policy of forcing contributions, by way of fines for alderman and sheriff, in an effort to bring income and output into balance. The chamber had reaped £17,600 from such fines in 1639. There were two chief causes for the rising debt, both of which had been called to the attention of the court of aldermen by a committee of its own members in 1627. The first was an easy loan policy, by which money was lent to merchants and companies at the same rate or even at a lower rate than that allowed by the city to the orphans whose money it was. The second cause was the willingness of the city government to pay out of the chamber costs which should have been borne by taxpayers. Furnishing ships to the navy in time of war, extending the water supply, rebuilding city gaols, paying military expenses in time of war—such costs should not have been met from the chamber.

There was rapidly developing a need for a settled tax revenue. Income from traditional sources not being sufficient to meet even regular expenses, the city followed the practice of exacting a special levy for unusual expenditures. But evasion and resistance to such special assessments were hard to overcome. The city had to accept the burden of seizing and marketing goods from those unwilling to pay, or must find satisfaction in the courts through actions for debt. This was a slow and costly way to collect revenue. There needed to be built up a habit of paying regular rates, an attitude of mind in the Londoner in which he would accept the financial responsibility of citizenship. Until a revenue far in excess of that in the decade preceding the Civil War could be assured, the chamber of London must continue to sink ever deeper into debt.

FORFEITED CAPITAL STOCK SUBSCRIPTIONS[1]

RICHARD H. HOMBURGER

NEW STOCK of a private corporation may be issued for cash or other consideration payable immediately or it may be offered for subscription, with the provision that payment is to follow at a later date. If a subscriber to capital stock does not pay for his shares at the time when such payment is due, his shares may be forfeited to the corporation, depending on the law of the state of incorporation, the provisions of the corporation's charter, and on the particular situation.

Various accounting methods have been designed to record the transactions incidental to such forfeiture of stock subscriptions on the books of the issuing corporation; however, the treatment of these cases is not uniform. The main difficulty lies in the fact that the procedure for forfeiture of subscriptions is largely governed by statutory law and that the statutes of the different states contain different rules on the subject. This situation is further complicated in that some of these rules are open to different interpretations, in that certain questions of law have been decided differently by different courts even under the same statute. Finally, difference of opinion as to how far accounting procedure should be adapted to statutory rules may lead to different results.

It is attempted here to analyze the legal factors involved in order to find an accounting procedure best suited to show on the corporation's books those facts which are financially relevant.

REVIEW OF STATUTORY PROVISIONS

General classification.

Some statutes do not provide for forfeiture of subscriptions at all or leave its regulation to the by-laws of the corporation. Of those states making some provision for forfeiture, the majority requires that the delinquent shares be offered for sale at auction before they can be forfeited. A smaller group of states (New York, Texas, District of Columbia) does not provide for an offer at auction sale before forfeiture. Colorado, Illinois and Indiana give the corporation an alternative between immediate forfeiture and sale at auction. Under those statutes where the delinquent's shares are sold at auction the delinquent is entitled to any surplus collected from the sale over all charges due on the shares plus the costs of the sale while, on the other hand, he remains liable for any deficiency. (See the statutes of Massachusetts, Mississippi, Kansas, and Idaho.)

Of those statutes providing for a public sale of delinquent shares, some require sale to the highest bidder, whether or not the bid is sufficient to cover all charges due on the shares plus the costs of the sale. (Florida, New Jersey, and Mississippi.) The majority, however, provides that where no bid is received sufficient to cover all such charges and costs, the shares of the delinquent subscriber shall be forfeited to the corporation. Under Massachusetts law, in case of such a deficiency, the stock may or may not be sold; if, however, the stock is not sold, it is nevertheless not forfeited to the corporation. The delinquent subscriber, if he pays all instalments and charges due, is entitled to the

[1] This article is based on a thesis presented in 1946 in fulfillment of the requirements for the Master's degree at Columbia University.

shares and, on the other hand, remains liable for the amount due on the shares; if the shares are sold, he is liable only for the deficiency.

Delinquent's liability after forfeiture.

Another question to be raised is whether the forfeiture has also the effect of releasing the delinquent subscriber completely of his liability for the unpaid balance due on the shares, or whether he remains liable in spite of the forfeiture. The leading opinion in this country is that he is completely released but the issue is controversial. Courts in Michigan, New York, California and other states have held differently, an Illinois court has ruled that the continued liability of the delinquent subscriber after forfeiture could arise from the issuing corporation's charter, and this continued liability may even follow directly from the provision of a state law.[2] (See theKentucky law, par. 271, 110.) It follows that the accountant, when formulating his procedure for the recording of forfeited subscriptions, does well to consider not only the statutory provisions of the particular state, but also the leading opinion of the law courts and even the charter provisions of the issuing corporation.

Bidding-in provisions.

Under some statutes the corporation is expressly allowed to bid in the shares of the delinquent subscriber at the auction sale provided for by law; the majority of those statutes provides, however, that in this case the corporation must pay all charges due on the shares. (North and South Dakota, Nevada, Montana.) A further condition is that the bidding-in must not affect the rights of creditors and stockholders, the implication being that such a purchase may be paid only out of available surplus and must not impair the legal capital of the corporation. The statute of Maine makes express reference to this condition, but it also follows from the general principle of protecting stockholders and creditors of the corporation.

Liability of previous owners.

Where shares subscribed were transferred by the original subscriber before they were fully paid, the Massachusetts law provides that if the corporation choses to proceed by action at law against the delinquent shareholder, and if a judgement against the delinquent shareholder remains unsatisfied for thirty days, the original subscriber shall be liable to the corporation for the amount due. From the accounting angle, however, this subsidiary liability of the original subscriber does not call for any special procedure. Previous shareholders can be identified from the records of the corporation, and as long as a present shareholder's liability to the corporation still exists there is no need to keep a futher record of any subsidiary claims against others in case of failure of present shareholders. When such failure occurs a transfer of the claim can be made on the books by crediting the present shareholder now dismissed and by charging the person under subsidiary liability.

ACCOUNTING PROCEDURE UNDER STATUTES

Completed auction sale to outsiders.

When the delinquent subscriber's shares are sold at an auction, the delinquent is always entitled to any surplus collected from the sale, and he remains liable for any deficiency. Therefore, if a deficiency arises, it should be charged to *accounts receivable—delinquent subscribers*. A surplus arising from the auction sale should be credited to *accounts payable—delinquent subscribers*. Aside from this, subscription and auction sale are recorded in the usual manner: A *subscriptions receivable* account

[2] S. D. Thompson, *Commentaries on the Law of Private Corporations*, 1927, p. 623.

is charged with the price of the original subscription and credited for the amount paid by the subscriber. The remaining debit balance in the *subscriptions receivable* account due to the failure of a subscriber is closed out after the auction sale when the *subscriptions receivable* account is credited for the balance, cash debited for the amount received, and *delinquent subscribers* debited or credited for any deficiency or surplus arising from the auction sale. On the balance sheet *accounts receivable—delinquent subscribers* should be shown among the current assets, and *accounts payable—delinquent subscribers* among the current liabilities. However, those items should be listed separately.

Forfeiture of stock and instalments to the corporation.

Some authors treat forfeited subscriptions as a kind of treasury stock[3] or even maintain that under some statutes they are treasury stock.[4] However, no reference to that effect can be found in any of the existing statutes. On the other hand treasury stock is generally recognized as that kind of stock which was once issued as fully paid and later reacquired by the corporation. Forfeited stock was never fully paid and, from the financial angle, never issued. It is, therefore, unissued stock and should be treated accordingly, that is *capital stock subscribed* should be charged for the par or stated value of the forfeited shares, the delinquent subscriber credited for the balance owed by him, and *surplus from forfeited subscriptions* credited with the amount of payments made by the delinquent subscriber and not refunded to him. If the forfeited shares are later reissued at a discount, such discount may be charged to *surplus from forfeited subscriptions*. If it is desired to keep a separate record of forfeited shares, an account *forfeited subscriptions* is charged with the par or stated value of the forfeited shares. In this case the balance sheet could show the amount of stock originally subscribed, less the amount of stock forfeited, and the remaining balance of the stock subscribed. The surplus from forfeited subscriptions is shown as a part of capital surplus. If the forfeited shares are reissued at a discount exceeding the surplus from forfeited subscriptions, such excess may be carried in an account called *deficiency from forfeited subscriptions;* the balance of this account may be charged to capital surplus.

Where the delinquent subscriber remains liable to the corporation for any deficiency even after forfeiture of his shares, it seems best to credit *surplus from forfeited subscriptions* with the full par or stated value of the forfeited shares, debit *capital stock subscribed* with the same amount, and transfer the balance of the subscriber's account to *accounts receivable—delinquent subscribers*. Upon reissuing the forfeited shares for cash at a discount such discount is then charged to *surplus from forfeited subscriptions*. The remaining balance in the latter account releases the delinquent subscriber from his liability to the extent of such balance; his account is credited and *surplus from forfeited subscriptions* debited. It follows that the delinquent subscriber remains charged on the books, if the cash received from the reissue is less than the amount of his debt to the corporation. If the forfeited shares are reissued under an instalment plan, it is apparent that the old delinquent will be liable not only for the deficiency arising from any discount allowed to the new subscriber but also for the deficiency arising from the failure of the new subscriber to pay for the shares when such payments are due. However, in such a case the new subscriber is primarily liable and no cognizance would be taken on the books of the old

[3] S. G. Winter, *Advanced Partnership and Corporation Accounting*, 1934, pp. 87 ff.

[4] R. B. Kester, *Advanced Accounting*, 1946, p. 453.

delinquent's subsidiary liability at the time of the new subscription.

If the state law requires that the forfeited shares shall be reissued within a certain time after forfeiture, and the delinquent not only remains liable for any deficiency but is also entitled to any surplus collected from the resale, the par or stated value of the forfeited shares would not be charged to *capital stock subscribed* but better to a special account *forfeited subscriptions to be reissued*. A surplus collected from the resale would be credited to *accounts payable—delinquent subscribers*.

Purchase by issuing corporation.

Shares bid-in by the issuing corporation for the purpose of resale are properly recorded as treasury stock, under a suitable account title such as *treasury stock from unpaid subscriptions*. As generally the legal capital of the corporation must not be impaired by such a purchase, earned surplus or, if such is not available, capital surplus should be restricted in the amount of the charges assumed by the corporation in connection with the purchase. For this purpose *earned surplus restriction for treasury stock* is debited and the delinquent subscriber's account credited. A debit to *treasury stock* and a credit to *legal capital for acquired stock* in amount of the par or stated value of the shares acquired shows in memorandum form that the legal capital has not been impaired.[5] On the balance sheet, treasury stock from unpaid subscriptions may be shown as part of the stock issued but under separate heading.

If there is no intention to resell the share bid-in, an account *retired subscriptions* may be charged instead of *treasury stock*. As long as the corporation's legal capital has not been reduced such retired subscriptions may be shown on the balance sheet as part of the stock subscribed, under separate heading.

[5] For this method of recording treasury stock purchased, see R. B. Kester, *Advanced Accounting*, 1946, pp. 449 ff.

THE TEACHERS' CLINIC

S. Paul Garner

Editor's Note: Many of the experienced teachers, as well as some of the new ones, have developed devices and techniques for the presentation of certain of the knotty aspects of accounting, and it is felt that such suggestions might well be made available to the other members of the teaching profession through *The Teachers' Clinic.* Accordingly, contributions are hereby invited. Please address all correspondence to S. Paul Garner, School of Commerce and Business Administration, University, Alabama.

JUSTIFICATION OF AND EXPLANATION OF SINKING FUND RESERVES

G. Arnold Logan
University of Denver

Many students in elementary accounting courses and a smaller number in intermediate accounting, during the period devoted to the study of bonds payable and the related topics of discount and premium on bonds, bond sinking funds and reserves for bond sinking funds raise the question: "Why have a sinking fund reserve in addition to a sinking fund?"

A majority of the members of each class will usually accept and clearly understand the instructor's explanations: (1) that the sinking fund alone merely segregates cash for a designated purpose (the eventual retirement of the bonds) without restricting in any way the distribution of other corporate funds in the form of dividends so long as such funds exist and are accompanied by the presence of a credit balance in the surplus account; (2) that the accumulation of a sinking fund is a clear indication that the stockholders propose to pay off the bond issue from funds accumulated out of current earnings over a period of years with the equally clear implication that such earnings must be left in the business (rather than distributed as dividends)—in other words, that the stockholders' investment in the business will be increased year by year until the total amount of the increase equals the amount of the bonds payable; (3) that the accumulation of a sinking fund reserve by appropriations from free surplus is the most effective way of safeguarding such retained earnings from stockholders.

Three assumptions are made for the sake of clarity and simplicity of illustration:

1. That $20,000 has been found to be a desirable minimum bank balance to handle seasonal peaks without borrowing.
2. That the stockholders have elected to leave a permanent credit balance of $5,000 in surplus (unless encroached upon by net losses) but feel that everything in free surplus over $5,000 should be distributed in dividends.
3. That the corporation is able to earn a net profit of $10,000 each year which through the turnover of inventories, receivables, and

Corporate Balance Sheet
(Immediately after floating bond issue used to purchase buildings)

Assets		*Equities*	
Cash	$ 20,000	Current Payables	$ 45,000
Receivables	30,000	Bonds Payable (10 years)	75,000
Inventories	40,000	Capital Stock	125,000
Plant and Equipment	160,000	Free Surplus	5,000
	$250,000		$250,000

payables shows up as an increase in cash and surplus at the end of each year (no other accounts being changed in the process).

The illustration is now carried through three years to compare the accounts and the general condition of the company under:
Policy I—The company accumulates a sinking fund but no reserve.
Policy II—The company accumulates both fund and reserve.

be maintained throughout the entire ten year period during which the retirement of the bonds is being anticipated.

The "T" accounts at the end of the 3rd year will be as shown at top of facing page.

The illustrative problem as presented above requires from thirty to forty minutes depending upon the amount of discussion stimulated.

The instructor should take pains to point out that formal reservations or ap-

POLICY I

1st year entries:
- a. To introduce the $10,000 profit
- b. To deposit $7,500 in sinking fund
- c. No entry
- d. To declare $10,000 dividend
- e. To pay $10,000 dividend

2nd year entries:
- a, b, c, d, e—same as for 1st year

3rd year entries:
- a, b, c—same as previous years
- d. To declare $7,500 dividend
- e. To pay $7,500 dividend.

POLICY II

1st year entries:
- a. Same as for Policy I
- b. Same as for Policy I
- c. To appropriate $7,500 for sinking fund reserve
- d. To declare $2,500 dividend
- e. To pay $2,500 dividend.

2nd year entries:
- a, b, c, d, e—same as for 1st year

3rd year entries:
- —same as 1st and 2nd year.

The illustration is presented in "T" account form with the two "policies" most effectively presented by setting them up on adjacent black boards. By the end of the third year the contrast between the two policies has become clearly defined. The corporation pursuing Policy I has been stripped of its cash leading perhaps to borrowing, interest expense, and lower net profits in the future. Future dividends must obviously be curtailed to the level of those steadily paid under Policy II"—probably even smaller dividends would result from the inevitably reduced profits. The company's operating condition has suffered badly even though it is the proud possessor of a $22,500 sinking fund (untouchable for operating purposes).

The corporation following Policy II will be seen to be in the same good condition in which it started the first year's operations. Its smaller but steady dividends can

propriations of free surplus are not essential to the attainment of the objectives gained under Policy II. The accumulation of a large free surplus balance at the rate of increase of $7,500 per year will accomplish the same results. Such accumulation of free surplus represents a program of voluntary self-denial on the part of the stockholders. Such a program may be difficult to support over a prolonged period especially when changes occur in the personnel of the stockholders and board of directors. A program of annual appropriations of surplus for the sinking fund reserve, when stipulated as one of the conditions of the bond indenture, generally will be found easier to execute with less stockholder resistance.

Although not an integral part of the problem illustrated above an excellent opportunity is afforded thereby to illustrate the special entries required at the

POLICY I

Cash

B 20,000	1b 7,500
1a 10,000	1e 10,000
2a 10,000	2b 7,500
3a 10,000	2e 10,000
	3b 7,500
	3e 7,500

Sinking Fund

1b 7,500	
2b 7,500	
3b 7,500	
(Balance 22,500)	

Receivables

B 30,000	

Inventories

B 40,000	

Plant & Equipment

B 160,000	

Current Payables

	B 45,000

Bonds Payable

	B 75,000

Dividends Payable

1e 10,000	1d 10,000
2e 10,000	2d 10,000
3e 7,500	3d 7,500

Capital Stock

	B 125,000

Free Surplus

1d 10,000	B 5,000
2d 10,000	1a 10,000
3d 7,500	2a 10,000
	3a 10,000

POLICY II

Cash

B 20,000	1b 7,500
1a 10,000	1e 2,500
2a 10,000	2b 7,500
3a 10,000	2e 2,500
(Balance 20,000)	3b 7,500
	3e 2,500

Sinking Fund

1b 7,500	
2b 7,500	
3b 7,500	
(Balance 22,500)	

Receivables

B 30,000	

Inventories

B 40,000	

Plant & Equipment

B 160,000	

Current Payables

	B 45,000

Bonds Payable

	B 75,000

Dividends Payable

1e 2,500	1d 2,500
2e 2,500	2d 2,500
3e 2,500	3d 2,500

Capital Stock

	B 125,000

Free Surplus

1c 7,500	B 5,000
1d 2,500	1a 10,000
2c 7,500	2a 10,000
2d 2,500	3a 10,000
3c 7,500	(Bal. 5,000)

Sinking Fund Reserve

	1c 7,500
	2c 7,500
	3c 7,500
	(Balance 22,500)

end of the tenth year (Policy II).

10. f. To return the sinking fund (cash and/or securities) to the general cash account.

10. g. To retire the bonds.

10. h. To return the sinking fund reserve to free surplus.

10. i. The possible (and highly appropriate) disposition of the large free surplus by means of a stock dividend. The free surplus reached the total of $80,000 through the enforced retention of earnings in the business. In other words the stockholders, by foregoing dividends, have invested an additional $75,000 in the business. They are entitled to receive additional capital stock as evidence of their increased investment, should they so elect. A dividend in any other form is not likely to be feasible, even if possible.

It may also be pointed out that the accumulation of an adequate sinking fund reserve, in the absence of a contractual requirement calling for a sinking fund will (without a sinking fund) place the corporation in a better position to retire the bonds when they mature and to *continue successful operations* than would be likely if the sinking fund alone is built up without an accompanying reserve. There is, of course, the danger that the "protected" increase of $75,000 in assets may be invested, to greater or less degree in noncurrent assets during the ten year period. The Board of Directors, intelligent enough to accumulate the assets and the surplus to accomplish the desired objective, would certainly be alert enough to lay down investment rules which would avoid dangerous pitfalls.

TEACHING THE APPLICATION OF FUNDS STATEMENT

CHARLES T. ZLATKOVICH
University of Texas

Solution of application of funds statement problems seems to be accomplished by many students more as a result of their memorization of rules and processes than because they have a basic understanding of what the statement seeks to accomplish. The student who understands the essential nature of the funds statement is not baffled easily when confronted by a unique situation which his previous homework or classroom demonstration problems did not parallel. In an effort to achieve the desired sound grounding in fundamentals of funds statements the writer has reduced his first class discussions to a very elementary level.

The result has been more satisfactory than previous efforts to teach the topic by conventional and more erudite approaches. The extreme simplification process is presented primarily on the blackboard. Needless to say the remarks and observations are not as terse as they have been made below.

Stage 1. The student is asked to assume the existence of a newly formed radio broadcasting corporation which leases its studio and equipment. Before engaging in operations its balance sheet consists of:

Cash	$10,000	Capital stock	$10,000

Working capital = $10,000.

Stage 2. After revenues of $5,000 are collected and expenses of $1,000 wages and $2,000 rental have been incurred, if all but $200 of the expenses were paid in cash, the balance sheet would appear as follows:

Cash	$12,200	Accrued wages	$ 200
		Capital stock	10,000
		Profit for period	2,000

Working capital = $12,000, an increase of $2,000.
Funds applied = $2,000 to working capital increase.
Funds provided = $2,000 profit for period.

Observations: The normal tendency of profits is to increase working capital by the same amount (exceptions will be noted later); an increase in working capital is an application of funds.

Stage 3. The owners decide it might be more profitable to own the fixed assets; so the leasing arrangement is discontinued. New fixed assets costing $25,000 are acquired; to help finance purchases, $20,000 additional stock is sold. The $200 accrual was paid. The new balance sheet would show:

(See top of facing page)

Observations: Payment of a current liability has no effect on working capital; a working capital decrease constitutes a provision of funds.

Stage 4. Revenues for the next operating period were $5,000 billed, of which $4,000 was collected. Expenses paid consisted of $1,000 wages and $400 property taxes; other expense incurred was $700 depreciation. The next balance sheet would show:

(See second table on facing page)

Observations: Obviously the important point of Stage 4 is that depreciation must be added to profits to arrive at total source of funds. The subject of dividends was deliberately delayed so that this one point,

Stage 3

Cash	$ 7,000	Capital stock	$30,000
Fixed assets	25,000	Surplus	2,000

Working capital = $7,000, a decrease of $5,000.
Funds applied = $25,000 to the purchase of fixed assets.
Funds provided = $20,000 by the sale of stock; $5,000 by the decrease of working capital.

Stage 4

Cash		$ 9,600	Capital stock	$30,000
Receivables		1,000	Surplus	2,000
Fixed assets	$25,000		Profit for period	2,900
Less reserve	700	24,300		

Working capital = $10,600, an increase of $3,600.
Funds applied = $3,600 increase in working capital.
Funds provided = $2,900 by profits and $700 by depreciation.

somewhat baffling to many students the author has found, would stand out.

At this point it may be desirable to continue the above technique but to set up a new illustration involving a merchandising activity.

Stage 1. The beginning balance sheet was as follows:

Cash	$ 5,000	Accounts payable	$ 1,000
Buildings & fixtures	7,000	Mortgage notes	3,000
Building site	2,000	Capital stock	10,000
Parking lot	1,000	Surplus	1,000

Working capital = $4,000.

Stage 2. Purchased $6,000 of merchandise on account; sold merchandise costing $5,400 on account for $8,000. Made payments on account of $4,000; collected $6,000 on account. Expenses paid in cash amounted to $2,000; depreciation was $100. Paid a cash dividend of $1,000 (using entire surplus). Balance sheet would then appear as follows:

Cash		$ 4,000	Accounts payable	$ 3,000
Receivables		2,000	Mortgage notes	3,000
Inventory		600	Capital stock	10,000
Buildings & fixtures	$7,000		Profit for period	500
Less depr. reserve	100	6,900		
Building site		2,000		
Parking lot		1,000		

Working capital = $3,600, a decrease of $400.
Funds applied = $1,000 to payment of dividend.
Funds provided = $500 by profits; $100 by depreciation; $400 by reduction of working capital.

Observations: Through these relatively simple summary transactions the effect of income and expense transactions on working capital can be emphasized; net profits were exactly equal to working capital changes until the depreciation was recorded.

Stage 3. Assume the same starting point as for Stage 1 of this second series. Assume also the same transactions as are given for Stage 2 plus two additional transactions: a. Parking lot was sold for $1,200 cash, the gain being taken up through profit and loss; b. A bad debt reserve of $50 was provided, but no accounts were written off. The balance sheet then shows:

(See top of next page)

Cash		$ 5,200	Accounts payable	$ 3,000
Receivables	$2,000		Mortgage notes	3,000
Less bad debt reserve	50	1,950	Capital stock	10,000
			Profit for period	650
Inventory		600		
Building & fixtures	7,000			
Less depr. reserve	100	6,900		
Building site		2,000		

Working capital=$4,750, an increase of $750 (as compared with Stage 1).
Funds applied=$1,000 to payment of dividend; $750 to increase in working capital.
Funds provided=$650 by profits; $100 by depreciation; $1,200 by sale of lot (which totals $1,950), but minus $200 for the gain on sale of lot (non-working capital credit).

Observations: Two new points were brought out here. First, that increasing of a bad debt reserve by an offsetting expense charge has the same effect as any expense which results in the increase of current liabilities or the reduction of cash. Second, that non-working capital credits, i.e. items increasing income but not increasing working capital by a like amount must be shown as an adjustment of the final figure on the income statement.

The same technique could be carried further to illustrate other points. However, it is likely that time will not permit more of this "controlled transaction and few steps at a time" method. The writer has found that after use of this technique and a few transitional remarks the average student better understands the usual application of funds worksheet and works problems from reason and not by rote.

A COURSE IN CONTROLLERSHIP

J. Brooks Heckert
Ohio State University

A very large per cent of the accounting graduates who remain in the field of accounting ultimately work in the field of industrial or private accounting. So far as the writer knows, there are no accurate statistics on this percentage but it is probably in excess of ninety per cent. Many graduates go directly to industrial accounting positions and many others shift from public to private accounting work after a few years of experience in the public accounting field.

If the accounting graduate goes to a small company he may rather quickly find himself in a position of accounting responsibility. He may relatively soon become the "head accountant." He may in reality be the controller though he may not be glorified with that title. If he goes to a medium-sized or large company he will, if ambitious, aspire to move up through the "chairs" with the position of controller as his ultimate goal.

Since such a large part of our graduates will either become controllers or be striving toward that position, it would seem desirable that the curriculum should stress the problems and objectives of the controllership function.

There are still hundreds of small companies ($1,000,000 to $5,000,000 volume) and numerous medium-sized companies where the function of controllership is not well developed due to the lack of men properly trained in this field.

Much of the educational training requisite for work in the field of controllership is provided in such conventional accounting courses as accounting principles, production cost analysis, distribution cost analysis, auditing, systems, income tax, analysis of financial statements, budgeting,

etc. In addition, much valuable training is provided by the courses required or taken in the fields of economics, statistics, finance, marketing, production, personnel management, insurance, and business law.

There are, however, many problems met in the complex task of controllership to which little or no attention is provided in these various courses. Or, if some attention is given to various related problems, the emphasis is not directed to the task and responsibility of the man who must coordinate and direct all accounting and statistical activity to the promotion of sound business policies, efficient business operations, and harmonious internal and external relations.

It would seem to the writer that one of the final comprehensive courses in the curriculum of the university accounting major should well be a course in "Controllership." To stimulate further thinking relative to such a course, the following outline of contents is suggested.

PART I
The Function of Controllership

Accounting in relation to management
The work of controllership

Part II
Accounting Control of Operations

General problems of accounting control—standards
Control of sales
Control of distribution costs
Control of production costs
Control of administrative and financial expense
Control of cash and receivables
Control of inventories
Control of investments
Control of fixed assets
Control of liabilities
Control of capital, surplus, and reserves
Financial and operating trends and relationships

Part III
Accounting Reports

Internal managerial reports
Reports to governmental divisions and securities exchanges
Reports to creditors
Reports to stockholders
Reports to employees
Reports to public

Part IV
Administration of Controller's Department

Organization of controller's department
Office management and personnel problems
Office and accounting equipment
Physical inventory procedure
Selection of accounting periods
Periodic closing procedure
Maintenance of accounting manuals
Accounting procedure for vacation, retirement, and pension plans
Tax records and procedure
Insurance records and procedure and self-insurance plans
Corporate records and procedure
Maintenance and destruction of accounting records
Branch accounting procedure

Part V
Special Problems of Controllership

Relation of controller and public accountant
The controller's contribution to industrial relations
The controller and governmental regulations
Uniform accounting methods of the industry
The controller and trade association activities
Industrial accounting societies
The literature of industrial accounting

In presenting the above outline, it is assumed that the subjects of internal auditing and budgeting are adequately covered in special courses.

It should be emphasized that much more time would be required for some of the subjects listed than for others. The writer would place the major emphasis on Sections II and III.

One of the difficulties in presenting such a course is in securing a man of adequate training to present it. The ideal selection is, of course, a man possessing both executive accounting experience and ability to teach. In the larger universities such men should be available.

The major functions in industry are currently considered to be sales, production, personnel, finance, engineering and research, and controllership. Most certainly controllership has attained a position of coordinate rank with the other major functions. We have long had courses in sales management, production management, personnel management, and comparable courses for the other functions. Controllership is certainly of no less importance.

Several universities already provide such a course. Its consideration is recommended to others.

PROFESSIONAL EXAMINATIONS
A Department for Students of Accounting

HENRY T. CHAMBERLAIN

THE FOLLOWING problems were presented as the second half of the November, 1948 C.P.A. Examination in accounting practice prepared by the Board of Examiners of the American Institute of Accountants. Candidates were required to solve problem 1 and either problem 2 or problem 3 in four and a half hours. The weights assigned were: problem 1, 30 points; problem 2 or problem 3, 20 points:

A suggested time schedule is given below:

Problem 1	120 minutes
Problem 2	60 minutes
Problem 3	90 minutes

No. 1

Prepare from the following information a columnar worksheet, reflecting therein:

A. The transactions and adjustments necessary to be recorded on the books of both the branch and home office;

B. The assets and liabilities of the branch as at September 30, 1948;

C. The related income data for the year then ended, which will be required for the state franchise report.

The Phoenix Branch, an outlet of Ace Mart Co., receives its merchandise from its out-of-state home office at an interoffice billing price determined at 133 1/3% of cost at home office shipping point. Branch inventories are carried on the branch books, at the interoffice billing price.

The Phoenix Branch is required to file a separate state franchise report and for this purpose inventories are to be based on cost at home office shipping point without regard to transportation costs.

The trial balance before closing of Phoenix Branch of Ace Mart Co. as at August 31, 1948, appears below:

	Dr.	*Cr.*
Cash	$ 13,930	
Imprest cash fund	200	
Notes receivable	8,000	
Accrued interest income, October 1, 1947	190	
Accounts receivable	18,000	
Inventory, October 1, 1947, at interoffice billing price	12,000	
Sales		$ 56,200
Sales returns	2,500	
Sales allowances	3,815	
Shipments from home office and other branch (at interoffice billing price)	61,840	
Freight-in	3,064	
Home office merchandise account		61,840
Home office current account		11,309
Selling expenses	2,910	
Administrative and general expenses	4,150	
Interest income		1,250
Total	$130,599	$130,599

Related accounts in the books of the home office of Act Mart Co. show balances as at September 30, 1948, before year-end closing as follows:

	Dr.	*Cr.*
Reserve for bad debts—Phoenix branch accounts receivable (to be adjusted at year-end closing to 2% of accounts receivable)		$ 850
Reserve for interoffice profit on inventories—Phoenix branch 10/1/47		3,000
Branch furniture and fixtures at cost, acquired 10/1/43	$ 4,500	
Depreciation reserve—Phoenix branch furniture and fixtures (depreciation accumulated through 9/30/47)		1,800
Phoenix branch current account	11,423	
Phoenix branch merchandise account	64,800	
Shipments to branch (at billing price)		64,800

Transactions of the branch for September, 1948, as yet unrecorded because of illness of the branch bookkeeper, are summarized as follows:

1. Gross sales on credit, $12,000.
2. Sales returns, $600; sales allowances, $885.
3. Shipments from home office at billing price, $2,960; freight paid by branch, $195.
4. Selling expenses, $390, and administrative and general expenses, $750, paid in cash.
5. Cash collected from customers, $6,570; notes received on account, $2,100.
6. Cash remitted to home office on September 30, 1948, $2,500.

Other branch data as at September 30, 1948

7. Interest accrued on notes receivable, $204.
8. Accounts determined to be worthless and to be charged off, $595.
9. Actual petty cash on hand, $86. The petty cash paid out was for miscellaneous administrative expenses. A check to replenish the imprest cash fund was in transit from the home office as at September 30, 1948.
10. Inventory of Phoenix Branch September 30, 1948, at interoffice billing price $16,000.

Additional Facts

11. During the year, the home office incurred clerical and other expenses of $1,270 applicable to the Phoenix branch, also insurance on direct shipments to the branch of $185. These items, recorded in the Administrative and General Expense control account of the home office, are charged currently to branch operations subsidiary accounts on the books of home office.
12. The freight-in account on the branch books is found to include $300 of freight on merchandise intended for shipment to Phoenix branch but erroneously shipped to Bartonville branch and retained by the latter.

No. 2

From the following post-closing trial balance, prepared by the accounting department of the Alexander Company from its records at September 30, 1948, and the supplementary information outlined below, prepare:

a. a columnar worksheet, setting forth the necessary adjustments to the company's accounts; and
b. a corrected balance sheet as of September 30, 1948.

Accounts	*Debit*	*Credit*
Accounts payable and other current liabilities		$ 1,830,000
Accounts receivable	$ 3,800,000	
Bonds payable—4%—1952		2,000,000
Capital stock		4,000,000
Cash	1,983,333	
Deferred income (discounts receivable)		375,000
Discounts receivable	3,216,667	
Fixed assets	4,000,000	
Goodwill	80,000	
Notes payable		1,000,000
Reserve for depreciation		1,000,000
Reserve for losses (Receivables)		625,000
Surplus:		
Balance—October 1, 1947		1,915,000
Income for the year ended September 30, 1948		435,000
Treasury stock	100,000	
	$13,180,000	$13,180,000

It has been determined that the following transactions or circumstances have not been adequately considered by the company's accountants in the preparation of the above trial balance:

(1) Discounts receivable represent the uncollected balances of a considerable number of notes receivable, acquired on a discount basis, in the aggregate original amount of $3,750,000. The discount rate was 10% and the deferred income of $375,000 is the full amount of the discount at the dates of acquisition which were as follows:

Date	*Aggregate Amount*
June 15, 1948	$2,000,000
July 21, 1948	1,000,000
September 10, 1948	750,000

By their terms, the notes are collectible in equal monthly instalments over a period of 15 months. The management is of the opinion that the aggregate discount on the notes acquired should be regarded as earned over the life of the notes and has requested that the "sum of months' digits" method* of transferring discount to income be used. It has been agreed that this method is acceptable, but it has further been agreed that no discount will be transferred to income in the month of acquisition.

(2) The company executed a lease agreement in July, 1948, for a five-year period beginning September 1, 1948, which stipulated an annual rental of $10,000. Under the provisions of the lease, the annual rental is due on the first day of each lease year, but no rent had been paid or accrued at September 30, 1948.

(3) Real estate taxes are payable in two equal instalments on March 1 and September 1 of each year. The fiscal year of the assessing body ends on December 31, but taxes are actually assessed on January 15 and become a lien against the property on February 1 of the fiscal year to which they are applicable.

The 1948 taxes (due March 1 and September 1, 1948) were billed at $60,000, and were paid when due.

(4) A 2% dividend was declared on September 30, 1948, to holders of record on October 15, 1948. The dividend is payable on November 1, 1948.

(5) Under a contract with an advertising agency, payments of $110,000 were made during the year in connection with a direct mail campaign. The payments represented a deposit ($25,000) and services and expenses through August 31 ($85,000). A bill for services and expenses for the month of September has been received in the amount of $60,000. All payments have been charged to expense; no accruals are reflected in the records.

The contract was entered into and the program was commenced on June 1, 1948. The campaign is to continue until May 31, 1949, but benefits are expected to accrue over a

* For example, if notes were collectible in equal instalments over a five-month period, the following procedure would be used:

Month	*Sum of Months' Digits*	*Proportion of Deferred Income to Be Considered Realized*
1st	1	5/15
2nd	2	4/15
3rd	3	3/15
4th	4	2/15
5th	5	1/15
	15	

three-year period. The deposit is intended to serve as a working fund for the payment of day-to-day expenses by the advertising agency; it will be deducted from the agency's final billing.

Total expenditures under this contract are estimated at $400,000. The company engages in more or less similar campaigns almost continuously.

(6) Cash for the payment of the semi-annual bond interest, due October 15, 1948, was deposited in advance with the trustee in September. The transfer of cash was treated as a charge against income.

(7) Notes payable are all due prior to September 30, 1949.

No. 3

Based on the data below, prepare:

a. A worksheet to record the transactions relative to the Z County Hospital for the year ended August 31, 1948.

b. A balance-sheet of Z County Hospital as of August 31, 1948, which reflects a general fund, an endowment fund and plant fund.

The X Society, a fraternal order, which operated Z County Hospital for indigent members of the community, donated it on September 1, 1947, to the Village of H, in which it is located. The gift included all of the securities in the endowment fund (the hospital's principal source of income), as well as the real estate, equipment and other assets. Since the village had made no appropriation for the operation and maintenance of a hospital, gifts from public spirited citizens supplemented the endowment fund income to provide for operating costs during the first year of its operation by the village, which coincided with the village fiscal year. No part of the principal of endowments may be used for operations. Before the end of the year preparations were under way for a drive to raise funds to enlarge and improve the plant. Since no money was collected in connection with this drive during the year under consideration, all expenditures for plant improvements were paid out of the general fund, but will be reimbursed from the proceeds of the drive.

The following transactions occurred during the first year.

Contributions and Receipts

1. Hospital site—value	$ 25,000
2. Hospital buildings—value	200,000
3. U. S. Treasury bonds contributed as endowment, principal amount	100,000
4. Accrued interest on U. S. bonds at August 31, 1947	1,250
5. Stocks and bonds contributed as endowments (no accrued dividends or interest)—market value	1,300,000
6. Equipment—value	60,000
7. Life insurance policies assigned to hospital as endowments—	
Cash value $ 5,000	
Face amount 150,000	
(Hospital to pay future premiums)	
8. Contributions from Z County for hospital operations	10,000
9. Contributions from numerous individuals for hospital operations	20,000
10. Proceeds from sponsored charity bazaar	500
11. Interest received from U.S. Treasury bonds	2,500
12. Dividends from stocks	44,000
13. Interest from bonds, other than U.S. Treasury	12,000
14. Sale of stocks included in endowments at $27,000	52,000

Disbursements

15. Building improvements	$ 20,000
16. Equipment	15,000
17. Salaries	15,000
18. Food and dietary supplies	10,000

19. Medicinal supplies	20,000
20. Life insurance premium paid	2,000
21. Property insurance	5,000
22. Light, heat and water	1,000
23. Expenses of charity bazaar, announcements, etc.	15
24. Other operating expenses	4,000

Other Information

25. Cash value of life insurance held for benefit of hospital at August 31, 1948	$ 6,500
26. Contributions subscribed but not collected	5,000
27. Prepaid insurance at end of year	500
Balance in bank per bank statement at end of period	51,085

Outstanding checks amount to $3,300 and the last day's deposit of $1,200 is not included on the bank statement.

28. Upon completion of the $20,000 improvements to the hospital building it was appraised at $250,000.

Key to Transactions and Adjustments for table on the facing page

(1) To record September sales
(2) To record sales returns and allowances
(3) To record shipments from home office
(4) To record payment for freight
(5) To record selling and administrative expenses paid
(6) To record cash and notes from customers
(7) To record cash remitted to home office
(8) To accrue interest on notes receivable
(9) To write off uncollectible accounts
(10) To charge petty cash disbursements to administrative expense
(11) To set up cash in transit to reimburse petty cash fund
(12) To set up ending inventory
(13) To adjust freight account for amount applicable to Bartonville Branch
(14) To set up cash in transit from Branch to Home Office
(15) To adjust Home Office cost of goods sold
(16 and 16a) To adjust Branch Office cost of goods sold, reserve for inter-office profit on goods in inventory and inter-office reciprocal accounts.
(17) To adjust reserve for bad debts to 2% of accounts receivable and to adjust reciprocal current accounts. (2 entries)
(18) To record depreciation on furniture at Branch
(19) To combine certain Home Office accounts with Branch accounts:

Reserve for bad debts	$ 385.00
Reserve for profit in inventory	4,000.00
Depreciation reserve	2,250.00
	$6,635.00
Furnitue and fixtures	$4,500.00
Administrative & gen'l expense	1,455.00
Depreciation expense	450.00
	$6,405.00
	230.00

(20) To combine two general and administrative expense accounts.

Solution to Problem 1

ACE MART CO.—PHOENIX BRANCH
Work Sheet
September 30, 1948

Phoenix Branch Accounts	*Balances (per books)* Dr.	*Balances (per books)* Cr.	*Transactions and Adjustments* Dr.	*Transactions and Adjustments* Cr.	*Expense*	*Income*	*Assets*	*Liabilities*
Cash	$ 13,930.00		(6) $ 6,570.00	(7) $ 2,500.00			$16,665.00	
				(5) 1,140.00				
				(4) 195.00				
Imprest Cash	200.00			(10) 114.00			86.00	
Notes receivable	8,000.00		(6) 2,100.00				10,100.00	
Accrued interest income	190.00		(8) 14.00				204.00	
Accounts receivable	18,000.00		(1) 12,000.00	(6) 8,670.00				
				(2) 1,485.00			19,250.00	
				(9) 595.00				
Inventory, at billing price	12,000.00		(12) 4,000.00				16,000.00	
Sales		$ 56,200.00		(1) 12,000.00		$68,200.00		
Sales returns	2,500.00		(2) 600.00		$ 3,100.00			
Sales allowances	3,815.00		(2) 885.00		4,700.00			
Shipments received (cost of sales)	61,840.00		(3) 2,960.00	(16) 15,200.00				
				(12) 4,000.00	45,600.00			
Freight in	3,064.00		(4) 195.00	(13) 300.00	2,959.00			
Home Office—merchandise account		61,840.00	(16) 15,200.00	(3) 2,960.00				
			(17) 465.00					
Home Office—current account		11,309.00	(7) 2,500.00	(11) 114.00				$57,828.00
Home Office accounts combined with Branch accounts			(19) 230.00					
Selling expense	2,910.00		(5) 390.00		3,300.00			
			(10) 114.00					
General and administrative expense	4,150.00		(5) 750.00		6,469.00			
			(20) 1,455.00					
Interest Income		1,250.00		(8) 14.00		1,264.00		
	$130,599.00	$130,599.00						
Due from Bartonville Branch			(13) 300.00				300.00	
Bad debts			(9) 595.00	(17) 465.00	130.00			
Cash in transit			(11) 114.00				114.00	
Home Office Accounts (On Branch statements)								
Reserve for bad debts		$ 850.00	(17) 465.00					385.00
Reserve for inter-office profit on inventory		3,000.00		(16a) 1,000.00				4,000.00
Branch furniture and fixtures	4,500.00						4,500.00	
Depreciation reserve		1,800.00		(18) 450.00				2,250.00
Administrative and general expense	1,455.00			(20) 1,455.00				
Depreciation expense			(18) 450.00		450.00			
Home Office Accounts (Not on Branch statements)								
Phoenix Branch current account	11,423.00			(17) 465.00				
				(14) 2,500.00				
Phoenix Branch merchandise account	64,800.00			(16a) 15,200.00				
Shipments to Branch (Cost of sales)		64,800.00	(15) 16,200.00					
Cash in Transit			(14) 2,500.00					
Branch profit and loss			(16a) $16,200.00	(15) $16,200.00				
Home Office accounts combined with Branch accounts				(19) 230.00				
Net Income of Branch					2,756.00			2,756.00
					$69,464.00	$69,464.00	$67,219.00	$67,219.00

Solution to Problem 2

ALEXANDER COMPANY
Work Sheet
September 30, 1948

	Trial Balance Dr.	Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Assets	Liabilities
Accounts payable and other current liabilities...		$ 1,830,000.00		(5) $60,000.00 (2) 10,000.00		$ 1,900,000.00
Accounts receivable	$ 3,800,000.00				$ 3,800,000.00	
Bonds payable		2,000,000.00				2,000,000.00
Capital stock		4,000,000.00				4,000,000.00
Cash	1,983,333.00				1,983,333.00	
Deferred income		375,000.00	(1) $94,166.67			280,833.33
Discounts receivable	3,216,667.00				3,216,667.00	
Fixed assets	4,000,000.00				4,000,000.00	
Goodwill	80,000.00				80,000.00	
Notes payable		1,000,000.00				1,000,000.00
Reserve for depreciation		1,000,000.00				1,000,000.00
Reserve for losses		625,000.00				625,000.00
Treasury stock	100,000.00				100,000.00	
Surplus		2,350,000.00	(2) 833.33 (4) 78,000.00 (5) 35,000.00	(1) 94,166.67 (3) 15,000.00 (6) 3,333.33		2,348,666.67
	$13,180,000.00	$13,180,000.00				
Accured interest on bonds				(6) 36,666.67		36,666.67
Deposit with trustee for payment of bond interest			(6) 40,000.00		40,000.00	
Prepaid advertising			(5) 25,000.00		25,000.00	
Prepaid rent			(2) 9,166.67		9,166.67	
Prepaid real estate taxes			(3) 15,000.00		15,000.00	
Dividend payable				(4) 78,000.00		78,000.00
					$13,269,166.67	$13,269,166.67

Key to Adjustments

(1) To adjust deferred income account for earned discount. The sum of the digits 1 to 15 is 120.

Notes purchased in June 42/120 of $200,000.00	$ 70,000.00
Notes purchased in July: 29/120 of $100,000.00	24,166.67
	$ 94,166.67

(2) To set up the liability under the lease agreement.
(3) To record prepaid real estate taxes.
(4) To set up the liability for dividend declared.

(5) To adjust accounts for advertising expense:

Total expense to September 30	$145,000.00
Charged to expense (per books)	110,000.00
Unrecorded expenses	$ 35,000.00
Add deposit with agency	25,000.00
	$ 60,000.00

NOTE: No part of the advertising cost is deferred since the company engages in similar campaigns almost continuously.

(6) To record prepayment of bond interest.

Alexander Company
Balance Sheet
August 31, 1948
Assets

Current Assets			
Cash		$1,983,333.00	
Accounts receivable	$3,800,000.00		
Notes receivable, payable in monthly instalments over 15 months	3,216,667.00		
	$7,016,667.00		
Less provision for losses	625,000.00	6,391,667.00	
Deposit with Trustee for bond interest		40,000.00	
Prepaid advertising		25,000.00	
Prepaid rent		9,166.67	
Prepaid real estate taxes		15,000.00	
Total current assets			$ 8,464,166.67
Fixed assets		$4,000,000.00	
Less reserve for depreciation		1,000,000.00	3,000,000.00
Goodwill			80,000.00
			$11,544,166.67

Liabilities

Current liabilities		
Notes payable	$1,000,000.00	
Accounts payable and other current liabilities	1,900,000.00	
Accrued interest on bonds	36,666.67	
Dividend payable	78,000.00	
Deferred income on notes receivable	280,833.33	
Total current liabilities		$ 3,295,500.00
Bonds payable		2,000,000.00
Capital stock and surplus		
Capital stock	$4,000,000.00	
Earned surplus	2,348,666.67	
	$6,348,666.67	
Less Treasury stock	100,000.00	6,248,666.67
		$11,544,166.67

Solution to Problem 3

Z COUNTY HOSPITAL
Work Sheet
September 1, 1947 to August 31, 1948

General Fund	*Transactions*				*Closing Entries*		*Assets*	*Liabilities*
		Dr.		*Cr.*	*Dr.*	*Cr.*		
Cash	(1) $ (5)	89,000.00 3,015.00	(3) $	92,015.00				
Accrued interest receivable	(2)	1,250.00					$ 1,250.00	
Contributions from Z County			(1)	10,000.00	$10,000.00			
Donations			(1)	20,500.00	20,500.00			
Interest income, U. S. Treasury bonds			(1) (2)	2,500.00 1,250.00	3,750.00			
Dividends on stocks			(1)	44,000.00	44,000.00			
Interest income, other			(1)	12,000.00	12,000.00			
Due from Plant Fund	(3)	35,000.00					35,000.00	
Salaries	(3)	15,000.00				15,000.00		
Food and dietary supplies	(3)	10,000.00				10,000.00		
Medicinal supplies	(3)	20,000.00				20,000.00		
Life insurance premium paid	(3)	2,000.00				2,000.00		
Property insurance	(3)	5,000.00	(4)	500.00		4,500.00		
Light, heat and water	(3)	1,000.00				1,000.00		
Bazaar expense	(3)	15.00				15.00		
Other operating expenses	(3)	4,000.00				4,000.00		
Prepaid insurance	(4)	500.00					500.00	
Due Endowment Fund			(5)	3,015.00				$ 3,015.00
Surplus, General Fund						33,735.00		33,753.00
							$ 36,750.00	$ 36,750.00

Plant Fund						
Hospital site................	(6) $ 25,000.00				$ 25,000.00	
Hospital building............	(6) 200,000.00				220,000.00	
	(7) 20,000.00					
Equipment..................	(6) 60,000.00				75,000.00	
	(7) 15,000.00					
Fund balance...............		(6) $ 285,000.00				$ 285,000.00
Due to General Fund.........		(7) 35,000.00				35,000.00
					$ 320,000.00	$ 320,000.00
Endowment Fund						
U. S. Treasury bonds.........	(8) $ 100,000.00				$ 100,000.00	
Stocks and bonds.............	(8) 1,300,000.00	(9) $ 27,000.00			1,273,000.00	
Cash value of life insurance.....	(11) 1,500.00				6,500.00	
	(8) 5,000.00					
Fund balance................		(8) 1,405,000.00		$26,500.00		$1,431,500.00
Cash.......................	(9) 52,000.00	(10) 3,015.00			48,985.00	
Profit on sale of securities.....		(9) 25,000.00	$25,000.00			
Due from General Fund.......	(10) 3,015.00				3,015.00	
Increase in surrender value of insurance............		(11) 1,500.00	1,500.00			
					$1,431,500.00	$1,431,500.00

Key to Entries

General Fund

(1) To record cash receipts.
(2) To record accrued interest on endowment fund securities at August 31, 1948.
(3) To set up amount due from plant fund for building improvements and equipment.
(4) To set up prepaid insurance.
(5) To set up liability to endowment fund.

Plant Fund

(6) To record donation of building and equipment.
(7) To record purchase of building improvements and equipment and to record the liability to the general fund

Endowment Fund

(8) To record donation of stocks and bonds.
(9) To record sale of stocks.
(10) To record amount advanced to the general fund.
(11) To record increase in cash surrender value of life insurance.

Z COUNTY HOSPITAL
BALANCE SHEET
AUGUST 31, 1948

ASSETS		*LIABILITIES*	
	General Fund		
Accrued interest receivable on Endowment Fund securities.......	$ 1,250.00	Due to Endowment Fund.........	$ 3,015.00
Due from Plant Fund...........	35,000.00	Surplus.......................	33,735.00
Prepaid insurance..............	500.00		
	$ 36,750.000		$ 36,750.000
	Plant Fund		
Hospital site....................	25,000.00	Due to General Fund............	$ 35,000.00
Hospital building...............	220,000.00	Fund balance..................	285,000.00
Equipment.....................	75,000.00		
	$ 320,000.00		$ 320,000.00
	Endowment Fund		
Cash..........................	$ 48,985.00	Fund balance..................	$1,431,500.00
U. S. Treasury bonds...........	100.000.00		
Stocks and other bonds..........	1,273,000.00		
Cash surrender value of life insurance	6,500.00		
Due from General Fund..........	3,015.00		
	$1,431,500.00		$1,431,500.00

NOTE: Uncollected pledges amount to $5,000.00.

ASSOCIATION NOTES

E. BURL AUSTIN

ALABAMA

University of Alabama:

S. PAUL GARNER recently addressed the Birmingham chapter of Certified Public Accountants on the subject of standardization of accounting reports.

CALIFORNIA

The Pacific Coast Economic Association, meeting jointly with the West Coast membership of the American Accounting Association, devoted its twenty-third conference to the theme, "The Economic Development of the West."

There were approximately 35 members of the American Accounting Association present for the special sessions dealing with accounting. Arrangements for the regional meeting were in the hands of a special committee headed by IRA N. FRISBEE of UCLA. Serving as members of the committee were J. HUGH JACKSON, Stanford University; D. H. MACKENZIE, University of Washington; J. F. HALTERMAN, Santa Barbara College; GORDON J. MILLER, University of Utah; PERRY MASON, University of California; HAROLD R. CLARK, Brigham Young University.

Papers read at the accounting sessions were by MAURICE MOONITZ, University of California; THORNTON G. DOUGLAS, Price, Waterhouse and Co.; CHARLES W. LAMBDEN, San Diego State College; THOMAS W. LELAND, Texas A. and M. College; GEORGE W. ROBBINS, University of California; DONALD J. EMBLEN, Montana State University; and DAVID A. REVZAN, University of California.

University of Santa Clara:

Recent appointments include LOUIS F. BOITANO, O. ROBERT ANDERSON and PHILLIP N. ALLEN.

University of San Francisco:

M. P. KILGORE has recently joined the accounting faculty. KILGORE passed the California CPA exam in 1948.

LEON SCHILLER has been appointed to teach a professional course in advanced tax problems for lawyers and tax specialists.

Stanford University:

BARRETT F. MCFADON has resigned to enter private accounting practice. He has been replaced by OSWOLD NIELSEN, associate professor, from the University of Minnesota.

SHERMAN M. WYMAN, a practicing accountant, served as special lecturer in income taxation during the past year in the Graduate School of Business.

COLORADO

University of Colorado:

HERMAN I. ARENSON is serving as consultant to the auditor of the City and County of Denver in a revision of the classification of expenditures.

VINTON S. CURRY was on leave during the winter quarter, associated with a local firm of public accountants.

University of Denver:

SAM BUTLER has been appointed to the staff as associate professor.

DISTRICT OF COLUMBIA

The American University:

In cooperation with the District Controllers' Group, the University is offering an Institute on Retail Accounting during the spring semester with HARRY W. KETCHUM as coordinator.

Added as lecturers in accounting have been JOHN W. MCCLARE, assistant chief accountant with SEC; CHARLES H. SCHMIDT, of the Federal Reserve System; and PAUL J. SOUTHARD.

Catholic University of America:

Rev. BRIAN A. KIRN has resigned to go to Quincy College in Illinois. W. B. PAUL and EDWARD C. MOYNIHAN have been appointed lecturers in accounting.

GEORGIA

University of Georgia:

JOHN F. BURKE has recently received the CPA certificate from the State of Georgia.

H. M. HECKMAN recently addressed the Anniston chapter of NACA on the subject of use of charts in accounting.

ILLINOIS

Northwestern University:

DAVID HIMMELBLAU is a member of the committee on accounting procedure of the American Institute of Accountants. HIMMELBLAU spoke

on the topic "How Low Can Inventories Be Priced" before the NACA meetings held in Peoria and in Moline in recent months.

George Owen, formerly in public accounting, is teaching during the winter and spring quarters.

Southern Illinois University:

Mary Noel Barron joined the staff as assistant professor in the fall.

University of Illinois:

H. E. Breen and Dorothy Litherland have passed the CPA examination. C. A. Moyer has been appointed by John Wiley & Sons, Inc., to serve as co-editor of the Wiley accounting series with H. T. Scovill.

P. L. Freter and L. R. Huff have recently passed the Illinois State Bar Examination.

Professor Emeritus Edward J. Filbey has established a public accounting firm in Chicago with his son, N. V. Filbey. The latter serves as part-time instructor in accounting at the University.

INDIANA

Butler University:

Chester O. Egner has replaced William Shors as acting head of the department of accounting.

IOWA

Drake University:

Carroll H. Kinker has resigned to enter public accounting work. He was replaced by John K. Soule, formerly with a firm of CPA's.

Members of the department of accounting jointly presented a program on education for accountancy before the Des Moines chapter of the Iowa Society of CPA's in February.

University of Iowa:

Harold B. Eversole has resigned to accept a position with the Atomic Energy Commission, Chicago.

New instructors on the staff include Marvin H. Baker, Bruce Brown, Walter R. Brown, John N. MacKay, Elzy McCollough, Alan Polasky, Guy W. Trump, and Daniel L. Sweeney. Walter Brown, Polasky, and Sweeney are CPA's.

Sidney G. Winter is secretary-treasurer of the Iowa Board of Accountancy.

KENTUCKY

University of Louisville:

J. William Cundiff has been appointed instructor in accounting and business law. Cundiff received his CPA certificate from Illinois in 1948 and was likewise admitted to the Illinois Bar.

MASSACHUSETTS

Massachusetts Institute of Technology:

George L. Smith has been appointed instructor. John A. Beckett is serving as program director, Boston chapter, NACA. He recently addressed the New England chapter of the Institute of Internal Auditors on the scope of the internal auditor's responsibilities.

Ronald H. Robnett recently served as a member of a special advisory committee for the Department of the Army.

Thomas M. Hill is director of publications, Boston chapter, NACA.

MICHIGAN

Michigan State College:

S. B. Mead and Paul S. Mills are on leave for graduate study at Indiana University.

Recent appointments as instructor include Elizabeth and Howard Lauenstein, Charles P. Woods, and James G. Carter. D. S. Knooihuizen has resigned.

John W. Ruswinckel gave a paper on balance sheet presentation before the Saginaw Valley chapter of NACA and to the Lansing Accountants Association. Bruce Futhey delivered a paper before the latter group on income statement and surplus presentation.

MONTANA

Montana State University:

Donald J. Emblen spoke on the subject "Accounting Curriculum in Schools of Business Administration" before the annual meeting of the Pacific Coast Economic Association, in joint session with the West Coast membership of the American Accounting Association, in Los Angeles in December.

F. O. Rydell received his CPA certificate in 1948.

NEW YORK

Clarkson College of Technology:

George Oberst has joined the staff as associate professor. William D. Krebs has received the CPA certificate from the State of Wisconsin. Krebs, who is vice president of the Adirondack chapter of the Empire Association of Accountants, addressed the group recently on the 1948 tax law.

Allwyn L. Carty, Jr., is presenting a series

of lectures on accounting to supervisory employees of ALCOA at Massena, New York.

Long Island University:

Three representatives of the New York State Society who addressed the Accounting Society students were: WALTER N. DEAN, Society vice president; HAROLD G. ANKERS, of the committee on education; and WENTWORTH F. GANTT, executive secretary.

The University's Accounting Society was addresssed in November by WALTER B. MCFARLAND, head of the research staff of NACA.

New York University:

B. BERNARD GREIDINGER has been appointed professor of accounting in the Graduate School of Business Administration.

Pace College:

Recent action taken by the Board of Regents of the University of the State of New York has conferred college status on Pace Institute, granting it the authority to confer the degree Bachelor of Business Administration.

University of Rochester:

FRANK P. SMITH discussed trends in business education before the Rochester chapter of the Controllers Institute in February.

OHIO

University of Dayton:

FRANCIS G. MCGOVERN and JOSEPH JACKSON have been appointed assistant professor and instructor, respectively.

JOHN LEIBFRITZ is on leave of absence doing graduate work at the University of Michigan.

John Carroll University:

The accounting faculty for the current year consists of the following: WILLIAM F. SHORS as professor; JOHN A. SELISKAR as associate professor; JOHN W. ALBERSTADT, FRANK DEVLIN and FRANCIS J. MCGURR as instructors; L. PALMER FOX, ELMER F. FRANZ and JOHN J. LESLIE as lecturers.

ARTHUR J. NOETZEL, JR., is on leave of absence to complete his doctoral work at University of Michigan.

Western Reserve University:

T. M. DICKERSON was recently re-appointed to the committee on accounting procedure of the American Institute of Accountants. DICKERSON is also President of the Grand Council of Beta Alpha Psi, national honorary professional accounting fraternity. He addressed the Northeastern Ohio chapter of American Pharmaceutical Association recently on uses of accounting in drug store management.

PENNSYLVANIA

Drexel Institute of Technology:

GEORGE A. DIX and RICHARD A. STRATHMEYER have been appointed instructors in accounting. The former comes from Aluminum Company of America; the latter from Susquehanna University.

JOHN V. BOSCH and JACK L. MERTZ have resigned from the faculty. The former is going to DePaul University.

Grove City College:

F. A. SUMRALL has been appointed professor of accounting to replace JACK KENNEDY, now secretary of the Alumni Association of the College. SUMRALL takes the accounting work after a year's absence, prior to which he was for twenty years professor of commerce.

Lehigh University:

CARL L. MOORE and THOMAS C. KUBELIUS have been appointed instructors in accounting and business law, respectively.

CARL E. ALLEN is acting as Dean of the College of Business Administration in the absence of NEIL CAROTHERS.

University of Pennsylvania:

GEORGE A. MACFARLAND is serving as chairman of the University's advisory council for veterans and University coordinator with the Veterans Administration.

THOMAS A. BUDD recently addressed the Boston chapter of NACA on the training and selection of cost accountants.

ADOLPH MATZ is serving as director of publications of the Philadelphia chapter of NACA.

ARTHUR D. MAXWELL is a member of the committee on education of the Pennsylvania Institute of CPA's.

TENNESSEE

University of Chattanooga:

MARTHA F. HILL is teaching courses in accounting.

TEXAS

Baylor University:

MONROE S. CARROLL, formerly Dean of the

School of Business, has been advanced to Dean of the University, and A. S. LANG, formerly Director of Economics and Business at Texas State College for Women has been named Dean of the School of Business.

North Texas State College:

O. J. CURRY is President of the Texas Association of University Instructors in Accounting.

Texas Christian University:

ROBERT H. GREGORY, formerly associate professor of accounting, has resigned to accept the position of assistant educational director for International Accountants' Society in Chicago.

WASHINGTON

State College of Washington:

JOSEPH TORBET has been appointed instructor. C. R. HAM was on leave of absence during the first semester.

WEST VIRGINIA

West Virginia Wesleyan College:

New additions to the staff include FRANK D. BERISFORD and JAMES R. WELSHANCE.

BOOK REVIEWS

CHARLES J. GAA

Standardized Audit Working Papers. Frederick Staples. (Milwaukee: The Counting House Publishing Co., 1947. Pp. 272. $4.50.)

According to the author, "this book has been written to promote discussion among practicing accountants regarding the practicability of standardized audit working papers and their value in further improving the quality of the work done by the average practicing accountant, and as a textbook for the student in accounting who seldom has the privilege of seeing a typical set of audit working papers covering an ordinary audit engagement." (Preface)

Standardized audit working papers differ from typical audit work sheets in that instructions appear on each sheet regarding the audit procedure to be followed, the extent of the audit work, and the information to be shown thereon. Accordingly, a "blank" standardized audit work sheet may have various column headings, questions, or audit points printed on the face of the working paper. Under this arrangement, at the start of any given engagement, the auditor's supply of working paper will not consist of a balanced quantity of seven column paper, fourteen column paper, etc., but rather a balanced quantity of cash paper, accounts receivable paper, inventory paper, etc. During the course of the audit, the auditor will accumulate the information prescribed by the established column headings, will answer all questions listed on the audit sheets and positively indicate that each listed procedure has been completed.

In contrasting standardized audit working papers with audit "manuals" or sets of standardized instructions, the author lists several disadvantages of the audit manual approach. One of the disadvantages associated with any attempt to standardize or guide audit procedures is the danger that the initiative of the auditor may be destroyed. This danger is clearly recognized by the author, but he believes that "it is becoming generally recognized that, if the initiative of the accountant is lessened by standardization, the blame for this should be placed on the supervisors and managers, and that with proper understanding of the purpose of standardization and adequate initiative on the part of those who supervise a reasonable amount of standardization will appreciably improve the quality of the work and will not tend to destroy the initiative of the accountant." (Page 5)

At this point, the author contends that "the accountant understands the object of standardized papers and usually does not have a feeling that they establish rigidity or restriction upon the exercise of judgment or initiative to the same extent as an audit program (as such) or a list of work to be done." (Page 6) In addition to being less restrictive on the exercise of judgment or initiative than audit programs or manuals, standardized working papers

(1) usually improve the quality of the work done;
(2) greatly facilitate the review of completed work;
(3) reduce the time devoted to instructions;
(4) may be numbered and indexed in advance ("It is a great advantage to have the work sheets indexed at all times during the progress of field work. . . . The average accounting firm usually feels it is too rushed during the busy season to take time to index its papers . . . "). (Page 7);
(5) provide a more convenient vehicle for communicating to the staff revisions and changes in accepted accounting procedure and tax laws;
(6) permit more complete and comprehensive work sheets without increasing the time devoted to an engagement.

With the case for standardized papers thus established, the author devotes one chapter to special phases of standardized working papers and another to a manual of general audit instructions designed for staff use. The remaining portion of the book is primarily concerned with special instructions for tax work or engagements covering more than one year. A sample audit report is illustrated and several appendices are devoted to illustrative sets of filled-in standardized working papers and reports. There is available an accompanying set of blank standardized working papers, prepared on typical accounting paper, complete with facing sheet and binding clip.

The author remains firm to his objective of presenting the best possible case for standardized audit working papers. Accordingly, there is no material on accounting or auditing theory. The fact that he may have overemphasized the importance of the subject and perhaps overstated some of the claims in its behalf is not a criticism; they naturally accompany his objective. The text material is concisely written, almost too concisely, with approximately three-fourths of the book being devoted to illustrations.

There can be no question that the topic is entitled to a full presentation to the profession. Certainly the greater the number of accountants who consider the case for standardized working papers and compare them with their own working paper approach the better. We should be certain that our working paper techniques are producing the best possible audit results.

HERBERT E. MILLER
University of Michigan

Auditing. Thomas W. Byrnes, K. Lanneau Baker, and C. Aubrey Smith. (New York: Ronald Press Company, 1948, pp. x, 738. $6.00.)

This book is one of the volumes in the University Accounting Series edited by Professor Roy B. Kester. Though it has been written primarily for the student who intends to become a professional auditor, the practitioner can probably find no better guide to sound, specific auditing principles, techniques, and procedures.

The chapter topics are essentially the same as those

used in most auditing textbooks written from the viewpoint of public accountancy. The first six chapters have titles as follows: The Field of Public Accounting; Organization of the Public Accountant's Practice; Planning and Beginning the Audit; Internal Control—Cash and Purchases; Internal Control—Sales, Securities, Fixed Assets, and Liabilities; Audit of General Records. Chapters 7 through 24 set forth in relatively great detail the procedures and techniques used in auditing the several balance sheet accounts. Chapters 25, 26, and 27 deal with the income and expense accounts and the closing of the audit. The last three chapters are entitled: Auditors' Reports; Special Investigations, Audit Techniques, and Auditing Standards; Ethics, Duties, and Responsibilities of Auditors. At the end of the book, 132 pages are devoted to questions and practice problems organized into 30 assignments which parallel the content of the 30 chapters.

The book has some features which merit special comment:

1. Detailed, step-by-step audit procedures are given. This type of treatment provides the student with background information on the mass of details with which auditing is concerned.

2. Case material illustrating various auditing problems and procedures is given throughout the text. The cases are excellent in portraying the reasons for certain procedures and the inadequacy of others.

3. A detailed audit program is presented and analyzed for each item on the balance sheet and for the major income and expense items. Students should be able to follow these presentations with real understanding and appreciation of the broad but specific nature of auditing.

4. The text gives very adequate treatment of internal controls in relation to auditing procedures and techniques.

5. The text, questions, and problems provide enough material for a six-hour course. On the other hand, it is believed that the book can be used more effectively in a three-hour course than those shorter treatises which are written in more general terms.

There is a 219-page Solutions Manual available for the questions and practice problems. The manual will be of much value to inexperienced teachers and of considerable convenience to experienced teachers.

The authors of this book have done a superb job; the book is well written from cover to cover. It should be examined by every auditing instructor who is contemplating an adoption.

GEORGE T. WALKER
Northwestern State College of Louisiana

How Tax Laws Make Giving to Charity Easy. J. K. Lasser. (New York: Funk & Wagnalls Company, 1948. Pp. xiv, 106. $3.00.)

Easily the most detailed study, from the tax angle, of the field of contributions, this concise, yet complete, book gives a thorough analysis of how to save the tax dollar by giving to charity and accomplishing one's eleemosynary instincts in the most practical way.

The treatise is broad in its treatment of the subject matter. Most people think of contributions primarily in the form of cash payments, but this book goes beyond the usual methods of pecuniary contributions and discusses donations in the form of appreciated property, securities, annuities, and the creation of foundations and charitable trusts. The problems of the individual, partnership, and corporation are treated separately, and the methods of translating intent into practicality are outlined.

As head of a New York tax accounting firm and as chairman of the Institute of Federal Taxation of New York University, J. K. Lasser, the author, has become an outstanding authority on tax subjects. In his latest undertaking, he uses the same treatment of his subject matter which made his *Your Income Tax* an annual best seller.

The sixteen chapters range from "How the Tax Law Aids Contributions" to "How to Organize a Group That May Receive Deductible Contributions."

Chapter Six, which deals with gifts by trusts out of income illustrates how an individual may obtain a 100% deduction of his charitable contributions by setting up a trust and after ten years receive back his entire principal. Under the usual method of treating contributions, an individual is limited to 15% of his adjusted gross income. This is but one instance of actual examples where a taxpayer interested in donating to charitable, educational, scientific, and religious purposes can do so with the greatest possible tax advantage.

The book is replete with tables showing savings in dollars and cents by using procedures advised. Great effort is made, successfully, to think in terms of reality, rather than theory. It can be of great value to charities and professional money raisers in that it presents all of the arguments and methods for giving to worthwhile organizations, and also shows how the donors can make these contributions at the lowest cost to themselves.

Of great interest to the reviewer was the chapter on the organization of groups that may receive deductible contributions, and the creation of foundations. These studies will be of particular interest to those colleges and universities, among others, which plan campaigns for increasing endowments.

For those interested in the field of contributions, both donors and recipients, this work will prove most helpful and illuminating.

CHARLES H. ZWICKER
New York City

Modern Corporation Finance. William H. Husband and James C. Dockeray. (Chicago: Richard D. Irwin, Inc., 1948. Revised Edition. Pp. xiv, 690. $5.00.)

This is the second edition of a text which has gained recent and favorable attention. The authors have retained as the central point of view the balancing of the interests of the corporation, the public and private investors, with substantial emphasis on the pattern of public control since 1933. There is, however, no radical departure from conservative economic philosophies.

"In stressing the importance of the public interest, it should be recognized that the public welfare is best

advanced by the proper encouragement of private interest." (p. 5.)

The logical organization of the book portrays the life cycle of a corporation. Part I of the present edition is a marked improvement over the 1942 edition. It contains an introduction, description of the various forms of business organization, a historical sketch of the development of the corporation and a discussion of the relationship between the corporation and the State. Following this, the student is introduced in turn to corporate securities, promotion, capitalization, sale of securities, management and ownership, expansion, failure and reorganization.

Particular attention is devoted to the purposes and provisions of the Federal laws passed between 1933 and 1940 which are administered by the Securities and Exchange Commission. Two concluding chapters explore the present and possible future relations between government and corporations. The authors envisage the continued extension of governmental controls, although the rate of expansion in such controls may be substantially modified by corporate policies designed to preserve the rights of investors, encourage economic stability and promote competition.

The criticism may be offered that the emphasis throughout the book is on the large corporation, with the result that the student is given little guidance for future small business organization. Although the book is already somewhat too large, for a one-semester text, the four chapters devoted to a description of various types of bonds might be condensed somewhat in order to permit the addition of illustrative material on the promotion, organization and raising of capital for small businesses. The chapter on sources of capital would benefit from greater attention to term lending and private placement of securities.

Chapter XI on promotion and financial planning is less satisfactory than the treatment in the earlier edition and gives inadequate attention to the economic importance of promotion and the functions of the promoter.

The discussion of "Rights On" (pp. 292–93) lacks charity and would be benefited by a clear definition of what is meant by a term used to only a limited extent in financial circles.

The chapter on executives and their compensation, which seems logically to fall in with the material in Chapters XIV and XV on the ownership and management of corporations seems inadvisedly placed in the latter part of the book as Chapter XXVII.

Chapter XXXI on failure would benefit from data of recent studies by the Department of Commerce and Dun and Bradstreet, illustrating the high rates of turnover in many small business lines and the prevalence of non-legal remedies for failure. The usefulness of the cases cited would be enhanced by the addition of recent historical financial information. This is particularly evident in the Chicago Great Western reorganization case under Section 77 (p. 624) since the wartime recovery in earnings illustrates the difficult problem of valuation in reorganization.

The emphasis in the text is upon the flexibility of the accounting device as an instrument of corporate policy The discussion of surplus and reserves is clear and should be cause for rejoicing among accountants, who are highly critical of the treatment of these subjects in corporation finance texts.

The authors frequently allow themselves to slip into statements of conclusion without giving beginning students the basis for evaluation. Statements such as are found on pages 57, lines 13–14, and 323, lines 1–5, provide interesting material for class discussion, but must be interpreted with caution for the beginning student.

The authors are to be complimented on having achieved a lively writing style with the maintenance of high standards of scholarship. New and up-to-date illustrations are used throughout the present edition to avoid an encyclopedic presentation and to convey to the student the highly interesting substance of corporate financial policies.

The present edition is a timely revision of a well conceived, soundly planned and useful textbook.

Paul F. Wendt
University of California at Berkeley

Marketing Principles and Methods. Charles F. Phillips and Delbert J. Duncan. (Chicago: R. D. Irwin, 1948. Pp. 714. $6.00.)

In evaluating a text in marketing principles it is important to keep in mind the nature of such a book and the basic purpose which it is designed to serve. Any such text is designed primarily to give the student a broad outline of the activities and institutions involved in getting goods from the hands of those who create or extract them into the hands of those who will consume them, to suggest some of the principles underlying such activity, and to apply these principles to some of the more fundamental problems involved in the process.

In line with this purpose, the subject matter and organization of the book are similar to most other texts in the field. It deals with the nature, scope, and significance of marketing activity and mentions the various functions and institutions involved in marketing in Part I. In Part II, it takes up the ultimate consumer and the consumer market and then treats the industrial user and the industrial goods market. Part III, composed of seven chapters, deals with retailing, giving detailed consideration to the more important types of retail institutions. Part IV devotes four chapters to a similar treatment of the wholesaling of consumer goods. In Part V, the marketing of industrial goods is considered. This part deals with manufactured industrial goods, raw materials, the commodity exchanges, and cooperative marketing by farmers. Part VI is composed of seven chapters dealing with the functions of market research, buying, selling, and pricing, together with the problems and policy decisions involved in performing them. Part VII is a single chapter devoted to government relationships to marketing.

Like most such texts, this book combines the institutional and functional approach, with just a "pinch" of the commodity approach.

One of the outstanding features of this book is that it actually accomplishes the basic purpose of such texts, referred to above, to a greater extent than any other the writer has read. It will give the reader, whether a layman, a student of business, or a business man an excellent orientation in the field of marketing. This is, perhaps, the most important contribution such a book can make.

Although the description of marketing institutions is entirely adequate, this book has more of the explanatory and analytical than is usually found. The excellent treatment in the first two chapters of the nature of marketing activity, the reasons for its development, and its place in the economic mechanism is a case in point. It is particularly good in showing the significance of the institutions and activities with which it deals, both to the individual firm and to the economy as a whole.

The whole book is characterized by simply worded, concise explanations; meaningful to the layman but based on sound economics and a broad knowledge of business practice. It is also more carefully and liberally documented than most books in the field.

While the table of contents differs little from many other texts in the field, the description and analysis of marketing institutions is unusually complete and the evaluation of marketing policies seems unusually careful and sound. The greater detail given and the accuracy from a practical viewpoint in describing such marketing institutions as the commodity exchanges, makes the material more understandable and interesting to the reader.

It should be noted that this text does not devote a chapter to each of the marketing functions as is done in some cases, although it does devote one or more full chapters to certain functions in Part VI. The writer will agree that little is lost by omitting detailed discussion of such functions as transportation and finance in an elementary text. However, a more detailed discussion of the storage and record keeping functions, particularly some material on distribution cost analyses, would add to the usefulness of the book.

The chapter on market research (chapter 23) is especially to be commended. It does an excellent job of giving a concise and meaningful picture of what market research is, what it can and cannot do, the basic steps involved in market research, sources of market information, and how firms can handle their market research activities. The principal weakness of this chapter, in the writer's opinion, is the failure to outline and evaluate at least the major techniques used in qualitative market analysis. In a very short space, the common impression that the survey method is the only available research technique could have been dispelled. However, the chapter is recommended not only for the student but for the general or departmental executive who wants a concise picture of the nature and significance of market research.

The chapter on selling policies and practices (chapter 25) is another example of the superiority of the text in giving an intelligent survey of the various phases of marketing activity. The thumb-nail sketch of the methods used and problems of administering personal selling and advertising should leave the reader with an adequate understanding of these activities, and it will also furnish the prospective specialist in the field a sound foundation for detailed study in specialized courses.

The chapters on price particularly show clearly the high quality of scholarship typical of this text. Marketing texts too often treat the whole matter of price in a somewhat superficial manner. This book gives a much more mature and comprehensive discussion of price. The chapter on non-price competition, giving the reasons for it and its effect upon the competing firm and upon consumers is simple, easy reading but sound economics, in the writer's opinion. The conclusions differ somewhat from those of Chamberlin and Robinson but are well supported. While the treatment of the economic effects of sales promotional activity leaves much to be said, it is about as much as could be expected in a general text.

The usual review of value theory is given in chapter 28 but the job of relating it to the business problem of pricing is unusually well done. A discussion of actual pricing policies and practices is given in chapter 29. Those who are familiar with *Marketing* by Charles F. Phillips miss the excellent analysis of the basing point system which it contained and which is greatly condensed in the book under review.

After having read and used as a text many of the best known texts in the field of general marketing, the writer believes that this is the most mature and scholarly, yet entirely practical effort to date.

CHARLES W. LEWIS

Alabama Polytechnic Institute

Dictionary of Modern Economics. Byrne J. Horton, Julien Ripley, Jr., and M. B. Schnapper. (Washington: Public Affairs Press, 1948. Pp. ix, 365. $5.00)

The subtitle of this book, which adequately decribes its nature, is: "A Handbook of Essential Information Concerning the Basic Terms of Business, Finance, Commerce, and Modern Economic Society." Its purpose is "to assemble and coordinate—primarily for the layman and incidentally for the college student—reasonably lucid definitions of those terms which cover the economic facts of life." The terms defined total approximately three thousand and are those which laymen and college students encounter most often.

This dictionary contains definitions, descriptions, or explanations of (1) basic economic concepts, (2) the terminology of business and finance, (3) governmental and private agencies in the field of economics, (4) digests of laws and Supreme Court decisions on economic matters, (5) citations to reference books for further nformation on certain topics, and (6) biographies of some persons who have made significant contributions to economics.

The economic, business and finance terms cover a wide range of subjects, for example: ability to pay, absenteeism, abstinence theory, acceleration principle, abstract of title, acceptance, actuary, administration,

adulteration, ad valorem, alloy, amalgamation, anarchism, annuity, deferred annuity, anti-trust laws, appraisal, appropriation, a priori, arbitrage, arithmetic mean, assess, National Recovery Code, Communist Manifesto, competition (in its many aspects), Congress of Industrial Organization (CIO), corn-hog ratio, corporation, cost (in its many aspects), "Cross of Gold," crusades, demand, demography, dollar diplomacy, dollar-a-year-men, duopoly, oligopoly, economics, Gary dinners, goon, Haymarket Riot, Lloyd's of London, Marshall Plan, money (in its many aspects), Robinson-Patman Act, slavery, slums, and utility.

Under the general heading of economic, business and finance items also are included many terms used widely in accounting. Some of the definitions and explanations in this area are incomplete or inaccurate to some important degree. Among the terms which require more adequate treatment are: amortization, appreciation, current assets, fixed assets, intangible assets, audit, capital, debit, depreciation, cost-plus contract, income tax, income tax deductions, reserve for depreciation, reserve for depletion, operating reserve, factory cost, internal check, net worth, normal tax, profit and loss statement, surplus, paid-in surplus, and wash sale. Perhaps, some part of these inadequacies may be excused, because the book is designed for laymen and college students rather than for experts.

Some examples of governmental and private agencies in the field of economics which are described include: Agricultural Adjustment Administration, Department of Agriculture, Agriculture Marketing Administration, Allied Commission on Reparations, Commodity Credit Corporation, General Accounting Office, American Arbitration Association, American Association for Social Security, American Bankers Association, American Economic Association, American Fair Trade Council, American Farm Bureau Federation, American Federation of Labor, American Home Economics Association, American Liberty League, American Management Association, Econometric Society and Economic History Association. The American Bar Association, National Association of Cost Accountants, American Accounting Association and the American Institute of Accountants are not described. The latter two are merely mentioned in the explanation regarding certified public accountant. It is interesting to note that the initials "CPA" are used only to denote Civilian Production Administration and are not identified in any way with certified public accountant, which is listed elsewhere as "accountant, certified public."

The biographies are short and are limited to those of economists; important persons in management, law, and accounting are not included.

In the discussion of some items, references are given to books which furnish additional information on the subject. The adequacy of such references may be questioned as to the breadth of the list of references and their basic importance. In their introduction the authors limit their responsibility, in these words: "These books are not necessarily the best or the most important works on the particular subjects involved. They are merely included by way of advising the reader where he is likely to find further information of a pertinent character."

The *Dictionary of Modern Economics* is an ambitious project which in the area of economics and business supplements the general dictionaries. It will be well if this dictionary is retained as a permanent publication and is revised frequently to clarify its contents and to keep it up-to-date. The book is printed attractively and is easy to read. For convenience, the arrangement is entirely in the usual alphabetical form of dictionaries. This dictionary should be a useful addition to the library of most persons interested in business affairs.

Charles J. Gaa
Uni ersity of Illinois

The Economics of John Maynard Keynes. Dudley Dillard. (New York: Prentice-Hall, Inc., 1948. Pp. 364. $3.00.)

This is not a work on the large and ever expanding field of Keynesian economics as developed by Hansen, Samuelson, Robinson, Lerner, and others, but is strictly an account of Keynes' theoretical system as set forth by Keynes himself in the *General Theory* and in his later writings. With its lucid presentation this book would have been appreciated much more if it had appeared ten years ago when even the best economists were trying to determine what Keynes' new system of economic thought was all about. But even at this late date Professor Dillard's work will be appreciated as an excellent, systematic rewriting of the *General Theory* in a form understandable to any careful reader. In fact the author has so scrupulously and thoroughly expounded the *General Theory* that there would seem to be no need for the general reader ever to refer to that wretchedly written book. As a textbook for advanced undergraduates (and probably for graduates as well) Professor Dillard's work should meet with great success.

What strikes one most on reading this faithful reproduction of Keynes' thought is the degree to which modern Keynesian economics diverges, at least in emphasis, from the work of the master. To Keynes the fundamental center of his system was his new and revolutionary liquidity preference theory of interest. But what now apparently seems fundamental to most contemporary Keynesians is instead the Keynesian idea of the consumption function. Many Keynesians appear to have adopted even the view that the liquidity preference theory is nothing more than the loanable funds theory of interest in another guise, even though Keynes emphatically rejected this position.

The explanation for this loss of interest in interest theory may be the fact that at the time Keynes wrote he was attempting to explain the nature of fluctuations in private investment activity as the cause of depression. Interest theory was made to explain the inadequacy of investment activity. It was impossible for the interest rate of the liquidity preference theory to fall sufficiently to guarantee at all times adequate investment activity for full employment. But for nearly ten years now we have heard little about the immediate inadequacy of private investment. Keynesian economics, originally thought of as a "depression economics," has now had to

justify itself as a device for analyzing inflationary conditions. Under these circumstances the consumption function has been emphasized as a tool for determining the inflationary rise in money income that will result from a given increase in government spending.

Professor Dillard does not discuss this development explicitly, but he does give an excellent picture of the use of Keynesian economics to analyze an inflationary situation, drawing in this case from Keynes' *How to Pay for the War*. In two concluding chapters on *Further Applications of Keynes' General Theory of Employment* and *the Development of Keynes' Thought* he shows clearly the way in which Keynes' theoretical constructs were always related to policy matters. Perhaps it might be said of Keynes that while he emphasized that the economic system was not self-adjusting he sought at the same time a self-adjusting theoretical system that would move on to answer new policy questions as they arose. The development of Keynesian economics from a "depression" economics to an "inflation" economics may be considered such a self-adjustment.

A. MORGNER

Texas A. & M.

Principles and Practices of Money and Banking. Charles R. Whittlesey. (New York: The Macmillan Company. Pp. xxiv, 688, $4.75.)

Professor Whittlesey has contributed an excellent text for a one semester introductory course at the intermediate level in money and banking. He has succeeded in his design "to explain in clear and logical form the essentials of money and banking as they exist today."

The author begins his presentation by explaining the framework of money and banking, and he subscribes to the definition of money as "that . . . which customarily and mainly performs money functions" (p. 4). He is well aware that legislators recognize bank notes as money but generally fail to recognize the monetary character of demand deposits. There is recognition of the "managed" nature of the international gold standard as practiced, and the legislative control in the operations of the "free banking system" (p. 17). The section on basic principles of money, banking and credit includes a discussion of the quantity theory of money which, "correctly interpreted, remains as valid as ever, and within the range of problems to which it is adapted is still a useful tool of analysis" (p. 87). A very good presentation is given of the principles of commercial banking, bank reserves and their limitation on deposit creation, and the fundamental banking problems. The author recognizes the increase in recent years in the holdings of bonds for bank investment which leads him to observe that "the amount of deposits is not limited to the volume of applications for bank loans by individual and business borrowers . . . and that the banks are not mere passive instruments in the process of deposit creation" (p. 136).

In order to comprehend the monetary history of the United States, the author believes one must understand the meaning and significance of Gresham's Law, which he defines as "Money that has value in a non-monetary use (including use as money in another country) will tend to move, if it is free to do so, to the use (monetary or non-monetary) in which its value is higher" (p. 188). Not much space is devoted to the development of the American money and banking scene prior to 1914; two thirds of the text deals with the subsequent period. About one sixth of the volume is allotted to the Federal Reserve System and its functions as a central bank, and the relations of the government to banking. It is here the author notes the importance of "moral suasion" as exercised by the officials of the bank and remarks that it is more influential than the officials have generally been inclined to acknowledge.

In the section on the financial developments since 1914 the discussion reflects a summarization of the various studies made by Professor Whittlesey of this period of the monetary and banking history of this nation. His experience as an economist for financial corporations has produced a down to earth consideration of the theories and trend of events during these years. In view of the many changes that have taken place in the banking system, "what has changed is not the mechanics of commercial banking but the foundation upon which the mechanism functions, namely, government debt in place of loans and discounts " (p. 431). Included in the Proposals for Financial Reform is a consideration of the income-expenditure approach to monetary theory and fiscal policy, and of fiscal policies for the maintenance of "full employment." Full employment is defined as "the utilization of productive capacity, material as well as human, at a high and continuing level" (p. 511). About one eighth of the book explores the current financial problems of inflation, deflation, the financial implications of the interest rate, and the importance of the national debt to our economy.

The discussion on international finance is limited to 60 pages, covering a brief description of the problem of foreign exchange, of international monetary principles and practices, and international financial reconstruction.

The author's style of succinctly defining the terms and concepts in the field of money and banking is refreshing. The table of contents presents a well integrated outline of the text, but there are missing lists of the charts, tables, and figures presented in the book, which number 33, 32, and 5 respectively. This omission is very disconcerting when reference to a chart is not located nearby; e.g., on page 367 reference is made to Chart XXII which is finally found on page 422. Some slips in proof reading are obvious; references to the chapters are in Roman numerals whereas the table of contents and chapter headings are in Arabic numerals; some charts have small errors; a line is mislabelled (p. 145), an ordinate scale omits a value (p. 492), and the crosshatching of a legend is reversed (p. 417). It should be mentioned there are no discussion questions at the end of chapters, nor suggested reading references for further study on particular topics.

J. F. HALTERMAN

University of California
Santa Barbara College

The Medici Bank. Raymond de Roover. (New York: New York University Press, 1948. Pp. xv, 98. $4.00.)

This book is a penetrating and interesting study of business policy in the fifteenth century. It is based upon an extensive and scholarly analysis of world-wide banking and trading operations of the Medici family. Much important material came from photostats of ancient documents (partnership agreements, correspondence, ledger accounts) made by the author in 1938 during a research expedition to Italy. The effective use made by the author of these materials is well reflected in this statement in the editor's foreword: "Other scholars have written of the Medici bank, but as none brought to the task the unusual training and abilities of Professor de Roover, none was able to transmute the fragmentary records into a satisfactory picture of a going concern."

The book clearly reflects seasoned scholarship. It is the scholarship of a team, for the author in the preface says that his wife, Florence Edler de Roover, "... should have signed the book with me." Both are Doctors of Philosophy; economics and history are good companion fields. Both are skilled in several languages: Latin, French, Flemish, Italian (medieval as well as modern); German and Dutch as needed.

Scholarship in this instance was also supported by an infectious enthusiasm for business history. Soon after the 1938 expedition I saw some of their scholarly booty and sensed their eagerness to see and tell the stories they felt were waiting there. This book is one of the fruits.

The text is set into two parts and a group of appendices, dividing the pages about equally. Part 1 deals with organization and management. The firm was a system of interlocking partnerships. Cosimo de Medici usually held a 50 per cent interest in each. In 1458, for example, he was a partner in eleven enterprises, most of which were foreign branches where the managers were junior partners. Although technically separate partnerships charging each other commission for services rendered, the branches were as closely supervised as departments of a single enterprise. Cosimo gave most of his time to supervisory activities, to making important decisions about policy and extending of credit, and to framing rules for the guidance of branch managers.

One of the chief contributions of the book is this showing that the managerial practices of this successful businessman were the kind which contribute to managerial success today. He gave close attention to business and made the major decisions. He trained his own lieutenants and helped them with clear instructions that were framework for the delegated responsibilities. And he visited the branches, or called staff meetings at headquarters in Florence, to discuss local and firm problems.

Part II considers the nature of the firm's financial and commercial operations. Firm activities included manufacture and sale of textiles, participation in merchandise ventures and a banking service in foreign exchange transactions.

Funds for use in the business were derived from several sources. Partnership capital and reinvested profits were obvious sources. Partners also made loans to the firm and time deposits were received from prominent people. Compensation even for these "loans" was a sharing in the profits; since interest was prohibited in that day, the lender's investment was like that represented by modern income bonds.

Funds in the enterprise might be employed in diversified ventures which could be single, or joint, or consignments. An interesting example of a venture in almonds is given detailed consideration in Appendix VII. Here there is a photograph of a 1441 ledger account for almonds. It shows the handwriting of a fifteenth century bookkeeper and is transcribed by the de Roovers for anyone who cannot read the bookeeper's hand, and translated into English for those who do not read Italian. Being an experienced practitioner of undecipherable script, I can appreciate the problem of learning to read such documents as this account. It is a real thrlll to see it done by Mrs. de Roover with the fluency of reading from a local newspaper. Such are the feats of scholarship.

This Almond account of 1441 presents some features of particular interest to accountants. The transactions recorded include shipping charges, rebate for damage, brokerage, custom duties, commissions, etc. We still charge such items into purchases account along with the invoice price; and with the same justification that made the practice useful in the fifteenth century. Another point is perhaps even more significant: these additions to invoice cost are redistributed from a Merchandise Expense account—other ventures or consignments receiving appropriate allotments of these joint costs. Isn't apportionment of expense a procedure now very characteristic of cost accounting? Evidently the main roots of modern accounting reach very deep.

It is noticeable also that no inventory was used to make an interim calculation of profit. The profit was apportioned to partners' accounts when the venture was terminated. Some who are troubled by conflicting modern views about inventory pricing may feel moments of envy. But the price of interim calculations is a priced inventory. If we want the one we must struggle along with the problems of the other.

Not much space is given to descriptions of the firm's manufacturing practices. The emphasis here is placed on banking practices and enterprise administration. Manufacturing operations and records of the fifteenth century are more fully treated by the de Roovers in other places. References are made to these in the footnotes. There were twenty-six steps in the process of manufacturing woolen textiles. Some of the work was done by groups of people under constant supervision, but much of it was carried on in the homes of the workers. Record making for control purposes would clearly be a large problem. Yet on the whole it seems to have been very well done, without, of course, approaching the cohesiveness of an integrated system of cost accounting.

The firm's financial operations usually involved remittances between agent and principal or drafts of one on the other. The bills of exchange involved two markets: a place of issue and a place of payment. Buying a bill was a way of lending (investing); selling was a

way of establishing a credit abroad. The remuneration to the participants came in the form on one side of a service rendered and on the other as profit, since interest (and discount) as such was prohibited. The banker found his compensation not in a borrower's fee for the use of money but in the difference between exchange rates of different foreign currencies, in changes in internal money markets, in variations in the balance of trade.

The accounting aspects of this type of business activity involves Vostro and Nostro accounts with branches or other distant correspondents. To record foreign exchange transactions understandably separate accounts are used according to whether the agent or the principal originates the transaction. In transaction analysis it is very important to see clearly who gets into (or out of) debt with whom. Since activities of this sort antedated full double entry bookkeeping (with its integration of real and nominal accounts), it is not surprising that textbook explanations of all kinds of accounts were for a long time made in terms of getting into debt, getting out of debt. The terms debit and credit were linked in accounting thought with debtor and creditor long beyond a clear justification for accounting use.

Some Vostro and Nostro accounts for 1441 are illustrated in the appendix sections. Transactions found in the ledger accounts are given careful explanation, including mention of items about notes protested and maker's or drawer's liability or contingent liability. On page 68, in a statement for settling a partnership in Lyons, allowance in the calculation is made for certain unpaid salaries: an accrued liability recognized at the early date of 1467. Today many people probably consider accruals and deferments as having a more important relation to income determination than to financial condition.

The evidence presented by Professor de Roover indicates that good methods of administration could produce a successful enterprise in the fifteenth century as well as in the twentieth. The study also shows that inept or careless management brought unsatisfactory results then as now.

The firm's long activity came to a close in 1494, with assets insufficient for the creditors. Cosimo de Medici succeeded his father in 1429 and died in 1464. One generation in the building of the firm; one generation of drifting into decline.

The factors contributing to this conclusion were mixed. The author indicates that Cosimo's descendants lacked his business acumen, had more interest in politics than in business policy, showed a tendency to drift from private financing into government financing. It is noteworthy too that early profits were largely reinvested, whereas later the profits were withdrawn to maintain a princely status for the head of the firm—Lorenzo the Magnificent.

Significantly linked with these were other financial factors. The source of much of the firm's resources eventually proved a weakness. Time deposits were in effect borrowed capital, sometimes bringing the depositor a return of 10 per cent. When the ratio of assets borrowed from creditors is high in relation to the assets invested by partners (including reinvested profits) the result is a weakened capacity to withstand deflationary conditions. When the monetary system and price structure drifts into widespread confusion, a financially weak and ineptly managed enterprise invites disaster which a stronger firm could possibly avoid. Add a tincture of political revolution, and even the founder's proven judgment might not have been enough to prevent collapse.

This lesson out of history shows that an enterprise organization is not self-sustaining; it needs a guiding mind, an interested and capable administration. Slack administration is likely to have a cumulative bad effect. Is this the reason that free enterprise and the profit test of the acceptability of enterprise service makes for better administration than does government operation wherein there is no comparably clear sign of effective or ineffective service?

This and other writings of the de Roovers show a fine competence in reconstructing the past with a clear perception of the present. The same competence would be invaluable for preparing an analytical history of double entry bookkeeping. Such a book would be a contribution to economic history as well as to the literature of accountancy, for the ideas worked out five hundred years ago for analyzing enterprise data were so fundamental that the whole structure of modern accounting was built upon them.

It is difficult to believe that the techniques of managing an enterprise could have progressed to the levels of today without the aid of accounting. What the literature needs now is not the mining of new facts but a skillful synthesis of the evidence already available to authors who are adept in several European languages. Besides picturing one feature of the growth of economic instruments, such a synthesis perhaps could also penetrate the "mystery" of double entry: What situations or ideas brought about the unique and characteristic integration of real and nominal accounts, of personal and impersonal accounts? Careful records were made of debts receivable and payable (financial transactions between debtors and creditors) long before the integrated structure of double entry had evolved. How were debt records converted into an instrument for calculating the periodic profits of commercial enterprises? Is it possible the the clue lies in Venture accounts where income and expense data were mingled with asset and investment data?

Without integration of real and nominal accounts there would be no accountancy as we know it, for this integration gives to the calculated income determinations of accounting a test for dependability that mere statistical tabulations could not supply. The periodic income figure is given support by being tied into the antecedent assets that produced it and into the subsequent assets which it helped produce.

A. C. Littleton

University of Illinois

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